INSIDE THE MINDS

# Buying and Selling Distressed Businesses

*Leading Lawyers on Navigating the Latest Bankruptcy Trends and Developing Strategies for Distressed Sales*

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# Developing Strategies and Overcoming Challenges for Distressed Purchases and Sales

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## Introduction

Chapter 11 practice is changing; the sale of a debtor's business, in whole or in part, has largely displaced the stand-alone plan of reorganization as the primary vehicle for restructuring a troubled business. Corporate lawyers and bankruptcy practitioners need to understand the procedural framework for a sale of a debtor's business under Chapter 363 of the Bankruptcy Code, 11 U.S.C. § 363 (2000), and the practical and litigation issues that may arise in such a transaction. While much of the sale process will be familiar to M&A lawyers, the procedures for a public auction and the judicial oversight are unique to the bankruptcy arena. In this chapter, we will examine the forces behind this trend, recap some recent notable transactions, discuss the procedural aspects of a Section 363 sale, and discuss successful strategies for buyers and sellers of distressed businesses.

## Recent Trends in Distressed Business Sales

*Selling as Opposed to Reorganizing*

In recent years, creditors have been successful in transforming Chapter 11 into a forum in which a sale of the debtor's business, in whole or in part, has substantially displaced the traditional Chapter 11 plan of reorganization. The most notable examples of this trend were the recent cases of Chrysler and General Motors, both of which were reorganized using sales under Section 363 of the Bankruptcy Code, 11 U.S.C. § 363.

There are several forces behind this trend:

1. A desire to reduce the amount of time a debtor spends in Chapter 11, thus also reducing the expenses of reorganization, including legal and other professional fees.
2. The increased willingness of bankruptcy judges to approve a sale of a debtor's business, in whole or in part, under Section 363 of the Bankruptcy Code, as opposed to a traditional plan of reorganization.
3. The rise of so-called distressed investors, who often put a premium on prompt sales to maximize the return on their investments.
4. The increasing tendency of debtor-in-possession (DIP) lenders to insist on short and strict timetables in DIP credit agreements to ensure a prompt disposition of a debtor's business.

*Reducing Expenses, Increasing Predictability*

The primary economic factor driving the changes to bankruptcy practice is a desire to reduce the expense and uncertainty of Chapter 11. Professor LoPucki of UCLA Law School has published a study indicating that the expenses incurred in a Chapter 11 case is strongly correlated to the length of the case. *See, LoPucki, Professional Overcharging in Large Bankruptcy Reorganization Cases*, 5 J. Empirical Leg. Stud. 983 (2006). Reducing the time that a debtor spends in Chapter 11 reduces that expense. And because in the overwhelming majority of Chapter 11 cases creditors are not paid in full, they directly bear the administrative expense of bankruptcy. Reducing the level of administrative expense thus increases their returns.

The other legal factor behind the rise of asset sales as a substitute for a plan of reorganization has been the increasing judicial willingness to accommodate Section 363 sales as an alternative to a plan of reorganization. The drafters of the Bankruptcy Code contemplated that the plan of reorganization would be the principal means by which a debtor's business would be reorganized. Accordingly, at first courts required debtors to have a strong business necessity for selling their assets in a Section 363 sale, and were skeptical of such efforts. *Committee of Equity Security Holders v. The Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983); *In re Continental Airlines Inc.*, 780 F.2d 1223 (5th Cir. 1986); *In re Abbotts Dairies of Pennsylvania Inc.*, 788 F.2d 143 (3d Cir. 1986). Those cases reasoned that because Congress had intended for plans of reorganization to be the norm, there had to be a substantial reason for departing from that paradigm in favor of a sale. Over time, however, judicial reluctance to approve Section 363 sales has faded as the judiciary has become more willing to heed the preferences of creditors. In effect, the judges have heard the message that the market has been sending.

*Turnaround Analysis in the Current Economic Environment*

One impact of the current recession is that the market for debtor-in-possession financing continues to be very tight. *See, DIP Loans Are Scarce, Complicating Bankruptcies*, Wall Street Journal (October 17, 2008), *available at* http://online.wsj.com/article/SB122421475294443955.html. Many banks have exited the DIP financing business entirely, leading to a reduction in competition on terms. While this gap has been filled to some degree by hedge funds and other non-traditional DIP lenders, overall the market remains difficult for Chapter 11 debtors. And where banks and other DIP lenders are making these loans, they are making them on very stringent terms, including short maturities and strict deadlines for confirmation of a plan of reorganization or a Section 363 asset sale. Thus, the lack of DIP financing on favorable terms has made traditional reorganizations more difficult and has hastened the trend toward the use of Section 363 sales.

In some cases, creditors believe that the underlying businesses are fundamentally strong, but that the capital structures have been overburdened with debt. The thinking goes that if the assets are sold free of the debt, the businesses will continue to be successful, albeit with a different capital structure. In other cases, the problem is not the debt, but the underlying business itself is troubled. In such cases, the business may need to be restructured operationally to be successful. The high-profile cases of Chrysler and General Motors are examples of these kinds of problems. In both cases, the companies suffered from high wage and benefit expenses and other types of burdensome legacy expenses. To reduce the cost structures of both companies, each debtor (with substantial assistance from the US government) sold its assets in a Section 363 sale, but in doing so jettisoned or left behind nonproductive assets or unfavorable contracts. Some two and a half years after its reorganization, GM is now profitable, and has paid back its government loans. Chrysler has also paid back its government loans and appears to be on a path toward profitability.

The final factor that investors are considering is the strength of the consumer economy. The widely followed University of Michigan Index of Consumer Sentiment, which measures consumer confidence about current and longer term prospects, reported that in July 2011, consumers were expecting an economic slowdown. Thomson Reuters, http://thomsonreuters.com/content/financial/pdf/i_and_a/438965/economic_slowdown_expected_by_consumers.pdf. In August, the index crashed to a preliminary reading of 54.9, the third worst score since the index began in 1952. The only lower scores came in May 1980 (51.7) and April 1980 (52.7) during a recession. Bradley Johnson, *Crisis of Confidence as Consumers (and Marketers) Brace for Downturn*, Advertising Age (Aug. 15, 2011), http://adage.com/article/news/sectors-vulnerable-downturn/229247/. Investors in businesses that depend on increasing consumer sales are highly attuned to changes in consumer confidence and data like this makes investors wary.

*Selling Rises as an Option While Other Options Fade*

The casualty of the trend toward Section 363 sales has been the traditional plan of reorganization in which the debtor continues its business with its pre-petition management. Chapter 11 cases still have plans of reorganization, but instead of that being the means by which the debtor reorganizes, now the plan simply serves as the mechanism for distributing the proceeds of the sale process and dealing with litigation claims.

The primary goal of a Chapter 11 case is the confirmation of a plan of reorganization. *In re Powell*, 187 B.R. 642, 647 (Bankr. D. Minn. 1995); 7 Collier on Bankruptcy ¶ 1129.01 (same). Confirmation of a plan of reorganization is the principal alternative to a sale of assets under Section 363 of the Bankruptcy Code. Generally, confirmation of a plan of reorganization is a two-stage process: first, the debtor files its plan of reorganization and disclosure statement. The disclosure statement is a document that contains information about the plan of reorganization, the factors leading to the Chapter 11 case, the treatment of creditors under the plan, and the debtor's proposed business plan. Before the plan may be voted on by creditors, the Bankruptcy Court must approve the disclosure statement as having "adequate information" to enable creditors to vote on the plan. 11 U.S.C. § 1126(b). A hearing on a disclosure statement must be held on at least twenty-eight days' notice to creditors. Fed. R. Bankr. P. 2002(b). After the disclosure statement has been approved, the plan is voted on by creditors.

The bankruptcy court then holds a hearing, on at least twenty days' notice, on confirmation of a plan of reorganization. *Ibid.* To be approved, a plan must either be accepted by each class entitled to vote on it, or approved over the vote of one or more dissenting creditors (a so-called "cramdown" plan under Section 1129(b) of the Bankruptcy Code). 11 U.S.C. § 1129(a)(7). Thus, the minimum statutory period from filing of the plan and disclosure statement until confirmation is at least fifty-six days. In practice, the interval from filing the plan and disclosure statement is typically significantly longer. This built-in delay is one reason why creditors are increasingly reluctant to go through the plan confirmation process until the assets of a debtor's business have been sold under Section 363.

*The Value Proposition: Benefits of Investing in Distressed Businesses*

There are many ways in which investing in distressed businesses can aid clients. For clients who are primarily distressed trading investors, there may be opportunities to profit either from identifying and acquiring generally undervalued businesses, or from identifying undervalued securities within the capital structure of a distressed business. For example, assume a business with a value of $50 million, with $40 million of first lien debt and $60 million in unsecured claims. At that valuation, the unsecured claims are implicitly worth $.166 on the dollar. Acquiring the claims at $.10 on the dollar should be profitable. Similarly, a distressed company that the market has valued at $50 million, and that produces $10 million per year of EBITDA, can be worth in excess of $50 million to a buyer who can acquire, eliminate duplicate costs, and increase the EBIDTA to $15 million.

Buyers evaluate distressed opportunities from the perspective of how they hope to profit. For traders, the primary variables are the likely rate of return, the time frame needed to realize that return, and the risk associated with the investment. For traders, each investment opportunity in a distressed company competes with each other opportunity, based on those same factors. For buyers who are not primarily bankruptcy investors, the same factors are likely to apply, but they also add in strategic factors that are not typically part of the analysis for a pure investor. Is this acquisition going to increase its market share or extend its product line? In addition, while bankruptcy investors are very concerned with time, which affects their rate of return on invested capital, strategic investors tend to be less concerned with that issue and more concerned with making sure that the investment is a good strategic fit with existing operations. But as is the case with bankruptcy investors, strategic investors weigh opportunities in this area against the non-bankruptcy alternatives.

**Notable Distressed Business Sales During 2010 and 2011**

Two notable distressed business sales in the past year were the sale of the Texas Rangers baseball team and the sale of satellite communications company DBSD North America Inc. The sales were of very different businesses: the Texas Rangers were a mature business, operating a professional baseball franchise in a lucrative market, while DBSD was a start-up business that had not yet begun operations, but still owned extremely valuable assets in the form of FCC radio spectrum. In the typical Section 363 sale, the Chapter 11 debtor enters into a purchase agreement with a prospective buyer, commonly referred to as a "stalking horse." While much of the purchase agreement will be typical of a negotiated acquisition, the key difference will be the inclusion of a set of procedures designed to facilitate a public auction for the debtor's business, which is designed to attract the highest and best price for those assets.

*Approval of Bidding Procedures by the Court*

Procedurally, the debtor will file a motion asking the bankruptcy court to approve bidding procedures for the auction and set a date for the approval of the sale. The bidding procedures will typically ask that the bankruptcy court approve certain protections for the benefit of the prospective buyer, including a "break-up fee" and, in some cases, the reimbursement of the buyer's out-of-pocket expenses, such as lawyers and financial advisors. The idea behind the break-up fee and/or expense reimbursement is to compensate the buyer for its time and effort in setting a floor for the auction process in the event that it is outbid at the auction. The legal standard for approval of break-up fees varies; in the Second Circuit, the test is whether the debtor used reasonable business judgment in approving the break-up fee, considering the size and complexity of the case. *See Official Comm. of Subordinated Bondholders v. Integrated Res. Inc. (In re Integrated Res., Inc.)*, 147 B.R. 650, 657 (S.D.N.Y. 1992), *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993). The Third Circuit applies the standard for allowance of an administrative expense—the proponent of the fee must demonstrate that it is actually necessary to preserve the value of the estate, which is considerably more rigorous. *In re Reliant Energy Channelview LP*, 594 F.3d 200 (3d Cir. 2009). When break-up fees are approved, they are typically in the range of 2 to 4 percent. While it is less common for a stalking horse to receive reimbursement of its out-of-pocket expenses, the lower the break-up fee, the stronger the argument for expenses.

The bidding procedures motion will also ask the bankruptcy court to approve the period of time during which the debtor and other interested parties will be able to search for alternative buyers, and for those buyers to conduct due diligence. The bidding procedures will also set forth criteria for who will be considered a qualified bidder, and will establish the bidding increments to be used in an auction, if it turns out that there is more than one qualified bidder. The bidding procedures will also set forth a date for competing bids and set the date for an auction, if one is to be held, and for bankruptcy court approval of the sale.

*Negotiating Terms of the Auction*

In the initial negotiations between the buyer and the debtor, the buyer will seek to conclude the post-petition auction as quickly as possible after the debtor files for Chapter 11, because the longer the business remains available for sale, the greater the possibility of finding additional bidders. The stalking horse will also want large bid increment to make it more difficult for a subsequent buyer to top the original bid. If the debtor has no strong alternative to the existing stalking horse, it will often have little negotiating power over these terms. However, because the bankruptcy court must approve these provisions, creditors, such as secured lenders and creditors' committees, can and often do negotiate to soften these provisions or, where such negotiations are not successful, object and ask the bankruptcy court to modify them.

Although bankruptcy courts have recognized the change in practice in favor of Section 363 sales, they are still concerned about ensuring that Chapter 11 debtors discharge their fiduciary duties by conducting a thorough and fair auction—one that does not try to inappropriately favor any prospective buyer. Thus, in seeking approval of bidding procedures, the debtor should outline the steps it has taken, if any, to market its business prior to filing for Chapter 11. That is particularly important if the debtor is seeking to sell the business quickly in Chapter 11; the debtor may seek to persuade the bankruptcy court that the pre-Chapter 11 marketing process obviates the need for a longer sale period in the bankruptcy. Chrysler successfully used that argument to persuade the bankruptcy court to approve its 363 sale approximately six weeks after it entered Chapter 11. Moreover, bankruptcy courts operate on the premise that creditors are entitled to full disclosure. *See, In re Medical Software Solutions*, 286 B.R. 431 (Bankr. D. Utah 2002). So debtors should ensure that all prior ties and relationships between a prospective buyer and the debtor are disclosed.

*Contact with Prospective Buyers*

Following the bankruptcy court's approval of the bidding procedures, the debtor and its financial advisors typically contact prospective buyers. Often the creditors' committee will also suggest candidates. Prospective bidders who express an interest are first screened to ensure their financial capability, and successful candidates are then given access to due diligence information concerning the debtor and its business. At the deadline for submission of bids, the debtor, typically in consultation with major creditors and the creditors' committee, will determine whether there are qualifying counterbids to the stalking horse offer. If there are bids, an auction will be held in conformity with the rules established by the bidding procedures. If there are no competing bids, the debtor will ask the bankruptcy court to approve the stalking horse's bid.

*Buyer Objectives: Profit and Status*

In the case of the Texas Rangers, the buyer was a syndicate formed for the purpose of bidding on and acquiring the team. As in any sale of a prominent professional sports franchise, the buyers had two objectives: acquiring a potentially profitable asset, and enjoying the cachet that comes from ownership of a highly desirable sports franchise. Dish Network Inc., a leading provider of direct-to-home video entertainment, acquired DBSD North America. Although DBSD is not yet operational, it has a substantial of broadband spectrum authorized by the Federal Communications Commission. Although Dish Network has not stated exactly how it will integrate DBSD with its existing business, analysts in the telecommunications industry have speculated that Dish Network may eventually use DBSD's spectrum allocation to broaden the voice and data communications services it offers.

*Creditors Shaped the Deals*

In both cases, the debtor had proposed different transactions from what was eventually approved. In the case of the Texas Rangers, who were eventually acquired by a group headed by former Texas Ranger pitching great Nolan Ryan, the original deal was for $575 million. The Rangers originally sought to have the bankruptcy court approve the deal at that price. But creditors objected, arguing that they were not convinced that that was the best possible price for the club. Because creditors argued that the initial deal was tainted by conflicts of interest, the bankruptcy court appointed a chief restructuring officer for the Rangers to conduct a fair and transparent sale process. That led to a bidding war between the group headed by Ryan and a competing syndicate headed by Dallas Mavericks owner Mark Cuban, which led to two improvements over the original deal: the purchase price was increased by $33 million, and the debtor retained control of two valuable tracts of real estate that were part of the original deal.

In the case of DBSD, the original bankruptcy plan was for approximately $780 million in first lien debt to be converted into 95 percent of the equity and a $40 million loan. That plan was initially approved by the bankruptcy court for the Southern District of New York over unsecured creditor objections, but the confirmation was overturned by the Second Circuit, which ruled that the plan violated the absolute priority rule. *In re DBSD North America*, 634 F.3d 79 (2d Cir. 2010). The absolute priority rule holds that unless a senior class has been paid in full or consents, no junior class may receive any distribution under a Chapter 11 plan of reorganization. 11 U.S.C. § 1129(b)(2)(B)(i). In *DBSD*, the plan provided that ICO Global Communications, the parent company of DBSD, would receive a 5 percent equity interest in the reorganized company. Certain creditors objected, contending that the grant of equity to the existing stockholders violated the absolute priority rule. The debtor argued that their first lien lenders had allocated that amount to ICO Global out of consideration that they would have otherwise been entitled to receive. Thus, they argued, the allocation was a valid gift under *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). The Second Circuit disagreed, holding that the so-called "gifting doctrine" was inapplicable in the context of a Chapter 11 plan of reorganization. 634 F.3d at 97.

In *DBS*D, Dish Network next offered to acquire DBSD for $1.1 million, an increase of approximately 40 percent over the initial plan valuation. In March 2011, Harbinger Partners also made a bid, which led to a full-blown auction for DBSD, which Dish Network won for approximately $1.4 billion, an increase of $620 million over the initial plan valuation. At that valuation, all creditors were paid in full, a dramatic improvement over the initial plan, which had provided no meaningful recovery to unsecured creditors.

*Important Lessons Learned for Counsel and Clients*

The message for both lawyers and clients is that bankruptcy courts are concerned that debtors actively seek to maximize the value of a debtor's assets in order to provide the best overall recovery for creditors. Thus, a debtor who asks a bankruptcy court to approve a bankruptcy sale must be prepared to offer evidence to the court that the debtor has run a fair, complete, and transparent auction process. For creditors who are seeking to challenge a transaction, it means that one avenue of attack is the fairness of the auction process. If creditors can establish that the process has not been robust, or has been designed to favor a particular bidder, they may be able to persuade the bankruptcy court to reopen process. For potential buyers, the lesson is that nothing is final in a bankruptcy court sale until the court has approved the sale (and any appeals are resolved). On a practical level, buyers need to understand that their initial bid will typically be subject to higher and better offers, and that it may be required to pay a higher price than its initial offer. In sum, the usual winner in a bankruptcy auction is the buyer prepared to offer the best price.

*Legal Issues in Rangers and DBSD*

The issue in the Texas Rangers case was whether the debtor had engaged in a full, fair, and transparent marketing process designed to obtain the highest and best bid. Through their objections, the creditors convinced the bankruptcy judge that plan had not been conducted in accordance with those standards, so he appointed a neutral third party to run a fresh auction. In DBSD, the issue was whether the plan improperly granted to ICO Global Communications, the pre-bankruptcy parent company of DBSD, stock in the reorganized business over the objection of the unsecured creditor class. As explained above, the Second Circuit determined that the DBSD plan violated the absolute priority rule and vacated the confirmation order, setting the stage for the eventual auction contest won by Dish Network.

**The Perils and Benefits of Non-Bankruptcy Sales**

In my experience, relatively few distressed businesses are now sold prior to bankruptcy. The typical distressed bankruptcy investor wants to acquire a distressed business without assuming the burdens of its debt load and its legacy liabilities and the uncertainty of additional litigation. In the cases where these transactions occur, the motivation for the seller is to avoid the time, expense, and stigma of bankruptcy. For some purchasers (but a small minority), the same concerns will sometimes lead to a non-bankruptcy transaction.

There are substantial risks to a non-bankruptcy sale. If the buyer has acquired the assets, but not the liabilities, and the seller subsequently becomes bankrupt, the buyer may have a fraudulent conveyance claim asserted against it. (Fraudulent conveyance is a claim in which the plaintiff asserts that the transferee has acquired the assets for less than fair consideration. From a buyer's perspective, the difficulty of fraudulent conveyance litigation is that it is highly fact intensive, making it difficult to dispose of the litigation until substantial discovery had been conducted.) In addition, in a non-bankruptcy sale, the buyer may face claims for state law successor liability claims arising under tort, labor, and environmental laws. By contrast, in a bankruptcy sale, the buyer takes title to the assets, free and clear of all liens, claims, charges, and encumbrances under Section 363(f) of the Bankruptcy Code. The ability to obtain a bankruptcy court order vesting title in the buyer free of such claims is an important reason why many buyers of distressed businesses prefer to have the assets sold in a Section 363 sale. However, the strength of the "free and clear" shield has been weakened in recent years as some claimants have been successful in imposing successor liability on Section 363 asset sale buyers for tort, employment, and other types of claims. *See Reed*, *Successor Liability and Bankruptcy Sales*, 51 Bus. Law. 653 (1996).

*The Benefits of Purchases in Bankruptcy*

The principal reason that buyers prefer to acquire the assets of a distressed business in bankruptcy is to obtain the benefits of an order that vests title free and clear of liens, claims, charges, and encumbrances. For sellers, a Section 363 sale has several benefits. First, it promotes an auction process that is designed to lead to the best possible price for the assets. That protects directors because once the debtor is in Chapter 11 they have fiduciary duties to creditors, which they discharge by obtaining the highest and best value for the assets. In addition, because of the oversight afforded by the bankruptcy court, directors who conduct an auction under court-approved procedures can be confident that their exercise of business judgment is unlikely to be criticized or challenged. Second, because a Section 363 sale allows a debtor to market the business without its liabilities, it may attract buyers who would otherwise be deterred from pursuing a non-bankruptcy acquisition. Finally, Chapter 11 provides a debtor with a forum for dealing with liabilities that may not be able to be handled outside of bankruptcy. A Chapter 11 debtor has the right to reject burdensome contracts under Section 365(a) of the Bankruptcy Code and Chapter 11 provides a convenient forum for centralizing any existing claims or litigation against the debtor. Utilizing a bankruptcy sale may allow a debtor to maximize the value of the assets while providing the most freedom to deal with the associated liabilities.

## Challenges Inherent to Distressed Business Deals

In the past several years, debtor-in-possession lenders have increasingly insisted on very short and strict timetables for a Chapter 11 debtor to either reorganize or sell its business. These short deadlines are designed to protect the secured creditors from the risk that the debtor's business deteriorates in Chapter 11, and to protect against incurring large administrative expenses. However, for the management of the debtor, these deadlines exacerbate the difficulties of the debtor's senior management team. In addition to the ordinary duties of running the business, the management will want to ensure that the fact of the Chapter 11 filing does not destabilize it. For debtors who have determined to pursue a sale of the business in bankruptcy, the primary responsibility of management becomes conducting a thorough and fair auction process and protecting against any deterioration in the business pending a sale. For a debtor that is still trying to determine whether to pursue a stand-alone plan of reorganization or an asset sale, its management and advisors must pursue a difficult dual track. They must be mindful that while they seek to develop a consensual proposal for a plan (and support it with an appropriate business plan and projections), they must also be prepared to pivot quickly to initiate a Section 363 sale process if they cannot develop a plan consensus quickly enough. For a management team that will also typically be trying to ensure the stability of the business immediately after the Chapter 11 filing, that dual challenge is particularly daunting.

The driving force behind these challenges is the change in the market for debtor-in-possession financing. Prior to the recent trend toward increasing utilization of Section 363 sales, DIP loans typically had maturities of eighteen months to three years. And while they may have had deadlines for filing a plan of reorganization, it was rare that a debtor had such a deadline within a year of its filing date. Now the market is quite different in two respects. First, the deadlines are far stricter. Today it is common for a DIP credit agreement to require that a Section 363 bidding procedures motion be filed within thirty to sixty days of the petition date. In addition, the deadlines tend to be more specific and more detailed, with specified dates for the filing of various motions and the receipt of various bankruptcy court approvals. In each instance, it is common for the failure to take such action or obtain such approval to be an event of default. Thus, the debtor today is under a far stricter regimen of lender supervision than in previous years. Some scholars have suggested that the balance of power, which Congress intended to be split between debtors and creditors with the enactment of the original Bankruptcy Code, has now been tipped so far in favor of lenders that they have now assumed *de factor* control of the process. *See Miller and Waisman, Is Chapter 11 Bankrupt?*, 47 B.C.L. Rev. 129 (2005).

*Risks to Buyers in Distressed Deals*

Buyers face several different forms of risk in a sale of distressed assets. The first risk is "process risk," meaning that the deal that the buyer thought it had obtained for the sale of the business is not obtained. In the case where the buyer is acting as the so-called stalking horse, it has typically negotiated a price for the business and has agreed on:

1. Bidding protections, such as a "topping fee" and perhaps reimbursement for actual expenses.
2. A schedule for obtaining bankruptcy court approval of the transaction.

In seeking to control the sale process while the debtor is in bankruptcy, the buyer hopes to have its bidding protection approved, and to prevent a full-scale multiple buyer auction from ensuing. The buyer's strongest weapon in that regard is the length of the due diligence period, meaning the amount of time that the debtor and other interested parties have to locate and contact other potential buyers, and for those buyers to conduct due diligence on the seller. The buyer's perspective is that the longer the assets are available for investigation, the more likely it is that other bidders will emerge, and conversely, the shorter the process, the less likely it is that other bidders will be attracted. Therefore, the buyer's biggest risks are that:

1. The bankruptcy court fails to approve the bidding protections it has negotiated for
2. A robust auction develops

This means that the buyer may either be outbid or be required to pay additional purchase price for the asset.

Once the buyer acquires the business, the biggest risk it faces is that creditors of the seller try to hold the buyer liable for various pre-petition claims, such as tort, labor, or pension obligations under various successor liability theories. While the bankruptcy court's order approving the sale will provide that the buyer acquires such assets free and clear of claims of the former seller, there have been a significant number of cases where buyers have been held liable on these theories.

*Losing the Bid During the Auction Process*

One of the hardest things for buyers who are not experienced with the dynamics of the bankruptcy auction process to accept is the idea that its initial bid, willingly accepted by the seller, may be topped through the auction process. For a buyer who is the subsequent winner in a competitive auction, having to pay a premium over what it initially considered a fair price is painful enough. Worse off is the buyer who is overbid in the auction process and walks away empty-handed. For some buyers, the payment of bidding protections, such as a break-up fee and/or reimbursement of transaction related expenses, can serve as compensation. Buyers who truly hoped to acquire the debtor's business are not likely to be consoled by payment of bidding protection payments. But such risks are a common feature of bankruptcy auctions, and so counsel for prospective buyers should make sure their clients understand the process thoroughly. All clients, but particularly those who are not experienced buyers of bankruptcy assets, need to understand that no agreement reached with a Chapter 11 debtor is final unless it has been approved by the bankruptcy court.

*More Client Risk: Erosion of the "Free and Clear" Doctrine*

The second class of risk that clients need to understand is that litigants continue to chip away at the "free and clear" doctrine under 11 U.S.C. 363(f). Creditors who have been injured by a Chapter 11 debtor are always searching for a more creditworthy defendant to absorb their losses, and a buyer of the debtor's business will always be an attractive target. Therefore, as part of the due diligence investigation, prospective buyers and their counsel should consider the nature of the business conducted by the debtor and the debtor's litigation history to make an informed judgment about what types of claims might be asserted against the buyer as a successor-in-interest, and how best to structure the acquisition to provide for the best defense for such claims.

*Complications Introduced by Bankruptcy*

Bankruptcy complicates the sale because it adds time, expense, and uncertainty to the process. In a non-bankruptcy acquisition transaction, a deal can be completed as soon as the parties have reached an agreement on documentation, and shareholder and regulatory approval, if required, have been obtained. As outlined above, the bankruptcy sale process has inherent time delays built into the sequence of obtaining approval for the bidding procedures, opening up the assets for due diligence and competing bids, and then the auction. Compared to a non-bankruptcy transaction, compliance with the bankruptcy sale regime tends to add expense to the process. And for both buyers and sellers, the presence of the court review process, and the possibility of other buyers surfacing, adds uncertainty.

*Legal Challenges to the Bankruptcy-Related Acquisition*

As detailed above, the acquisition agreement typically spells out how the parties will seek to obtain bankruptcy court approval for the bidding procedures. The acquisition agreement may also require the seller to provide advance notice of the filing of motions to the stalking horse. More importantly, the acquisition agreement will also typically contain provisions that limit the seller's ability to take any action that might have a material impact on the value of the business without the buyer's consent. The purpose of those provisions, from the buyer's standpoint, is to ensure that the business retains substantially the same value on the closing date that it did when the buyer entered into the purchase agreement. In other words, these covenants protect the basis of the buyer's bargain. If there is a breach of these covenants, the buyer may have the right to terminate the transaction or renegotiate the purchase price.

*Defending Against Bankruptcy and Fraud Claims*

It is common in bankruptcy sales for the buyer to receive no indemnity. The idea is that the risk of claims that might otherwise be the subject of indemnification should be reflected in the bid price. The seller's motivation for such a provision is clear: as a debtor, it wants certainty that the buyer will have no recourse against the purchase consideration. However, no contractual provision will protect the seller in the event that the buyer alleges fraud. For example, in Lehman Brothers, the debtors first sold the core of their US investment banking and asset management business to Barclays, and then sued Barclays, alleging that Barclays had improperly received a windfall of $11 billion. In a lengthy opinion, the bankruptcy court denied Lehman's claims, but only after more than a year of bitter litigation. *In re Lehman Brothers Holdings Inc.*, 445 B.R. 143 (Bankr. S.D.N.Y. 2011). The best way for a seller to protect against post-sale claims is not to grant a right of indemnity to the buyer. But as the Lehman case illustrates, there is no possible contractual protection against a claim alleging misconduct in the conduct of a bankruptcy sale.

*Common Errors in Acquisitions*

The most common mistakes in bankruptcy acquisitions are failing to consider the types of post-acquisition claims that may be asserted against the buyer and failing to understand the nature of the bankruptcy process. Both mistakes are most typically made by inexperienced bankruptcy buyers. The antidote for these errors is careful due diligence on the part of the buyer and its advisors, and in the case of counsel to the buyer, making sure that the client understands the bankruptcy auction process.

Most of the statutory provisions regarding asset sales in bankruptcy are well known to the bar. What changes—week to week and month to month—are common? What is the range of break-up fees currently being approved by judges in the Southern District of New York and the District of Delaware? Those are the key trends to follow. And the information is widely available; the *Wall Street Journal* regularly covers bankruptcy news, as does *The New York Times*. The actual court documents are available on the respective courts' websites.

## Developing Strategy for a Distressed Purchase or Sale

For any sale of a business, the critical issues are organizing the process so that all parties have a clear understanding of their responsibilities and their associated deadlines. Ensuring that those deadlines are met helps clients keep costs under control and keeps all parties focused on the overall timetable.

The paramount goal for a business lawyer is to understand the client's objectives at the beginning of each engagement. When representing a debtor, counsel has to explain the alternatives—an out-of-court workout, a reorganization that contemplates a stand-alone plan of reorganization, or a Chapter 11 case that will seek to affect an asset sale. When representing a buyer, counsel goes through a similar analysis: here the emphasis also contains a cost-benefit analysis because many buyers will have a self-imposed limit on what they are willing to pay for an asset. Once the client has made that determination, counsel can advise on the best strategy for acquiring the asset within the intended price range.

The goal of the initial planning sessions is to develop an overall strategy. Once that strategy has been determined, counsel can advise on the specific steps to be taken to implement that strategy. In the case of a sell-side engagement, the preparatory steps include preparation of due diligence materials, preparing the client executives to discuss the status of the business with prospective buyers, and, in some cases, preparation of an offering memorandum describing the condition of the business and its prospects. I also recommend that counsel and the client work together to develop a working timetable for the sale of the business, with each specific task being assigned to the responsible individuals at the client or counsel as appropriate. For a buy-side engagement, the next step is development of a due diligence strategy. The due diligence checklist should be based upon a current understanding of the client's business, supplemented by available public information about the target. After the scope of the due diligence has been set, the tasks to be completed can be assigned and deadlines set.

*Clear Roles for Participants is Crucial*

The size and composition of the team will be determined as a function of the size and complexity of the transaction. From the buy side, the core legal team will include bankruptcy and corporate lawyers. But depending on the issues involved in a sale, there may be need for tax, real estate, benefits, litigation, and environmental lawyers. From the client side, there is usually one person responsible for overall strategy. Depending on the client, that may be the chief executive, chief financial officer, general counsel, or head of acquisitions. The client team may be augmented with accountants, investment bankers, and industry experts, as necessary. In most cases, the sell side team will mirror the buy side team. Often, however, the sell side team may need more corporate lawyers to help assemble the due diligence materials, and more bankruptcy lawyers to help prepare the pleadings for a Chapter 11 filing and a Section 363 sale.

*Key Questions for Clients on the Buy and Sell Sides*

Counsel can never be too informed. Lawyers make mistakes when they rely on untested assumptions. From the buy side, counsel needs to make sure he understands the buyer's objectives as thoroughly as possible. To do that, he should obtain an understanding of the client's existing business, and how this acquisition fits within the client's overall strategy. He should also understand the particular risks generally faced by businesses in this industry, and he should ask whether his client has concerns about unique risks associated with an acquisition of the target. On the sell side, a lawyer should ask similar questions: why is a sale strategy being pursued, as opposed to an out-of-court transaction or a stand-alone reorganization? What are the legal risks faced by this particular seller. Are there risks of loss of revenue? Is retention of management a concern? Is the seller facing a cash squeeze, and if so, how is it addressing the issue?

*Common Client Questions and Concerns*

The primary client concerns regarding a sale of the business center on:

1. timing
2. expense
3. certainty

To address those issues, counsel should help his client understand how the bankruptcy sale process works, and how it affects each of these issues. In the current economic climate, lawyers should be prepared for clients to ask for a budget; in fact, volunteering to prepare a budget shows that the lawyer is concerned about overall costs and how to contain them.

**Negotiations for Distressed Business Sales/Purchases**

Sellers of distressed businesses have two concerns:

1. Obtaining the best price
2. Ensuring that the seller closes on the deal

To that end, sellers need to have a clear understanding of the value of their business. Depending on the size and complexity of the business, management alone may have sufficient information on market terms for a sale of a similar business to price their own business. But for large or unusual businesses, sellers may need the advice of financial professionals, such as investment bankers, to value their assets. Traditional valuation techniques include comparable transactions, such as discounted cash flow valuations. From those techniques, sellers can assess the likely value of their assets and thus can be in a position to assess the strength of competing bids.

Sellers must also prepare for the negotiation process by investigating their potential buyers. How strong is the buyer from a financial perspective? Does the buyer have a strong record of closing on potential acquisitions? Are there regulatory issues with any buyer? Only after the seller has formed a view about the strengths and weaknesses of a potential buyer is it prepared to negotiate with it.

In addition to the price, the key terms of an acquisition agreement are representations and warranties, the covenants regarding conduct of the business in the interval between deal signing and closing, and the closing conditions. These provisions are designed to work together to ensure:

1. That the buyer has a complete and accurate picture of the assets and business it is buying
2. That the buyer cannot take any action that would impair or change the nature or quality of those assets pending a closing
3. That the nature and condition of the assets on the closing date are substantially the same as they were when the acquisition agreement was executed

These terms are typically negotiated among the seller, its counsel and financial advisor, and their counterparts on the buyer team. The representations and warranties tend to be easiest; the closing conditions the most difficult. One can understand the tension; the buyer does not want to be obligated to close if the buyer's business is deteriorating pending a closing, while the seller wants the certainty that the buyer will not seek to renegotiate or terminate the deal.

*Effective Valuation Techniques*

The most common valuation techniques for distressed businesses are asset value, income stream, and comparable transactions/companies. Depending on the business or asset, more than one valuation technique may be used, and where various valuation methodologies are used, the relative weight may vary. For industrial companies, it is common for investment bankers to do the valuation work; in real estate cases, appraisers may be used. In smaller business cases, accountants or restructuring advisors may perform the valuations. In a non-bankruptcy sale, the parties can and do negotiate over valuation. In a bankruptcy auction, there is no negotiation over value. The debtor and the stalking horse will negotiate initially over valuation, but then the stalking horse bid will be exposed to higher and better bids.

The negotiating team for an acquisition will vary depending on the size and complexity of the transaction. In large and complex deals, the full legal team may be needed—i.e., bankruptcy and corporate lawyers plus various specialists. For smaller transactions, a single lawyer may be the primary negotiator, backed by additional resources as necessary. The same is true for client involvement; for a large deal, there will typically be a head of the transaction, whose team may include outside financial advisors and/or industry experts.

The due diligence list for a buyer is going to be broader than a typical non-bankruptcy acquisition and will focus more on issues relating to the condition of the assets, and less on corporate formalities such as historical minute books. In many bankruptcy sales, the representations and warranties do not survive the closing, and there is no indemnification of the buyer. The idea is that buyers should conduct extensive due diligence, and should not expect to be able to bring indemnity claims for breaches of representations and warranties after the sale.

*Using a Due Diligence Checklist to Guide the Process*

The due diligence checklist needs to be tailored to the nature of the business conducted by the debtor. What are the key assets? What are the sources of revenue? What types of industry-specific representations and warranties are contained in non-bankruptcy sales for a company in this industry? Working together, the lawyer, the prospective buyer, and its financial advisor can develop a pragmatic checklist that is aimed at developing a detailed look at the business. In addition, the buyer and its counsel should be sensitive to considerations of potential claims that may be asserted against the buyer post-closing. Therefore, it is important to understand the legal and business risks of the seller's operations. Does the seller have a large backlog of litigation? If so, counsel should carefully review and understand the nature and frequency of such claims?

The buyer and its counsel should also consider the seller's workforce, and issues that may need to be explored in this area include:

1. Wage and benefit levels and programs
2. Collective bargaining agreements
3. Pensions and post-retirement medical benefits, if any

The buyer also needs to consider whether it will retain any or all of the existing management team, or whether to replace them. If management is to be released, the buyer should consider whether to negotiate for non-competition agreements, or determine if they are already in place. The goals of any due diligence checklist are to:

1. Surface any legal or business issues posed by the historical operations of the seller's business, or the buyer's proposed operations post-closing
2. Put the buyer in a position to negotiate the strongest possible acquisition agreement
3. Assist in the negotiation of the purchase price

*The Cost of Due Diligence in Distressed Transactions*

The costs of due diligence will be a function of the size of the business, the amount of material to be obtained and reviewed, and the level of professional assistance required to review and consider the due diligence material. For small acquisitions, particularly an acquisition by an industry participant of a failing competitor, the buyer may not need to have industry or financial advisors to review the due diligence because the buyer may have the expertise and knowledge on its own. But in large acquisitions, and often in the case of acquisitions by financial buyers, the buyer may need the assistance of lawyers, financial advisors, accountants, and/or industry experts to assist in the due diligence process.

*Applying Due Diligence Information in Negotiations*

Information obtained during due diligence is used primarily to assist the buyer in negotiating the representations and warranties concerning the business to be purchased and in the negotiation of the purchase price.

Indemnification is a difficult issue in distressed business sales. Sellers are usually successful in resisting them; the argument they make is that the business is being sold "as is-where is" and that the buyer's bid should reflect its implicit indemnification concerns. Where buyers are successful in obtaining indemnities in bankruptcy sales, they tend to be of limited duration and for limited amounts of money. If the buyer gets an indemnity, it should insist that the money subject to indemnity claims be escrowed with a third party.

The best way for a seller to protect against creditor claims is to seek relief under the Bankruptcy Code; the automatic stay under Section 361 of the Bankruptcy Code precludes further creditor acts to collect debt or seize assets. The buyer's protection is a sold Section 363(f) order, transferring the assets free and clear of liens, claims, charges, and encumbrances. While a Section 363(f) order is generally effective, as noted above, it is not a bar to creditors seeking to impose successor liability claims on the buyer. *See Reed, supra.*

## Conclusion

I believe that the next two years will see an increasing volume of Section 363 transactions. It has been estimated that approximately $430 billion in debt of companies owned by private equity firms will mature from 2012 to 2014. *Private Equity's Looming "Maturity Bubble"*, N.Y. Times Dealbook (June 8, 2009), http://dealbook.nytimes.com/2009/06/08/private-equitys-looming-maturity-bubble/. Many of these companies may find it difficult to repay or refinance that debt, the consequence of which will be an increasing volume of Section 363 transactions.

My most valuable advice is to stay current on the terms of major transactions. The business press reports news of major cases; the *Wall Street Journal* has a "Bankruptcy Beat" area on its website and *The New York Times* "Dealbook" regularly covers developments in major cases. When I find something in which I am interested, I often go to the website of the bankruptcy court involved and obtain the actual case documents to review. It is important to stay current on the market; this is a dynamic practice, and something that worked five years ago may be out of date today.

**Key Takeaways**

- Counsel your client to avoid granting a right of indemnity to the buyer. As the Lehman case cited above illustrates, there is no possible contractual protection against a claim alleging misconduct in the conduct of a bankruptcy sale.
- Conduct careful due diligence to discern the types of post-acquisition claims that may be asserted against the buyer.
- Explain the options to your client: an out-of-court workout, a reorganization that contemplates a stand-alone plan of reorganization, or a Chapter 11 case that will seek to affect an asset sale.
- Work with your client to develop a timetable for the sale of the business, with each specific task being assigned to the responsible individuals at the client or counsel as appropriate.
- Determine your client's motivation to purchase by asking how this acquisition fits within the client's overall strategy, if he understands the risks faced by businesses in this industry, and whether he has concerns about unique risks associated with an acquisition of the target company.

**Related Resources**

- The Investment Agreement, as amended for the DBSD acquisition by Dish Network is available online through the ECF system of the United States Bankruptcy Court for the Southern District of New York, http://www.nysb.uscourts.gov/. In re DBSD North

America, Inc. is case 09-13061. The Investment Agreement and the First Amendment thereto are docket items 899 and 1023.

- The Asset Purchase Agreement for the Texas Rangers is available online through the ECF system of the United States Bankruptcy Court for the Northern District of Texas, https://ecf.txnb.uscourts.gov/. In re Texas Rangers Baseball Partners is case 10-43400 (DML) and the Asset Purchase Agreement, as amended, are docket items 34 and 554.

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