INSIDE THE MINDS

Buying and Selling Distressed Businesses

Leading Lawyers on Navigating Recent Distressed Business Transactions, Understanding the Sales Process, and Developing Deal Strategies

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A Few Essential Elements of Distressed Asset Transactions

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Introduction

My practice is focused primarily on the representation of debtors in commercial insolvencies, and potential acquirers of financially troubled assets. When dealing with the buying and selling of distressed businesses, I initially try to approach the issues as a businessman rather than as a lawyer. I try to understand the distressed debtor's business and/or the would-be acquirer's purchase objectives. At the same time, I try to anticipate the likely logical needs and positions that people on both sides of the engagement are likely to adopt. In a nutshell, the distressed asset transaction attorney needs to understand and evaluate the business objectives of the relevant parties. At that point, the law then becomes nothing more than a tool used to affect the desired end result. The key is to meld what the client is trying to achieve business-wise within the required legal framework. The lawyer's job is to make the transaction happen.

Recent Activity in Distressed Business Sales

The principle challenge to businesses posed by the recent recession was the tightening of the credit markets. When normal credit providers such as AIG, Bear Stearns, Lehman Brothers, and CitiCorp were reduced to having to go hat-in-hand to the government to maintain their solvency, the ancillary damage to their credit-needy friends and neighbors was predictable. Next in the domino credit lines were the companies that relied on those institutions to maintain their liquidity. After the bank bailout, the primary obstacle to economic recovery in the past year has been loan contraction and a lack of liquidity for many otherwise normally credit-worthy borrowers. There were many criticisms of the recent government bank bailout, but in my opinion, the bailout was necessary to save the national economy. Ultimately, the bailout enabled financial companies to once again begin to provide liquidity to their business customers.

Bankruptcies and distressed asset transactions occur even in the best of times. Distressed assets need to be examined on two levels. At the macro level, there is the need to understand industry issues. Are the problems pervasive at an industry-wide level? At a micro level, we need to look at the specific issues unique to the company in question. Is the company over-leveraged? Does the company have environmental issues, incorrect products, outdated equipment, or other operational issues? The lawyer must first consider the broad issues before focusing on the details of specific micro problems.

War Stories

Horsehead Industries Inc.

In addition to being the largest domestic producer of zinc, *Horsehead Industries Inc.*, 300 B.R. 573 (Bankr. S.D.N.Y. 2002) was one of the finest companies I have represented. Horsehead's basic business involved refining toxic mini-steel mill slag waste into zinc oxide. Despite being paid by the mini-steel mills to cart the slag away, Horsehead, at the end of its production cycle, unfortunately produced zinc oxide at thirty-eight to forty cents a pound in a thirty cent a pound buyers' market. Unfortunately, the company did not have the funds required to wait out the commodity market price cycle, and thus Horsehead, as a Chapter 11 debtor, had no choice but to sell its operating business to a distressed asset buyer in a Section 363 bankruptcy sale.

The financial benefits from the sale transaction included continued operation for the company, no job loss for employees, and potential profit for the distressed asset buyer. Because of the sale, a great company was saved, 1,000 people kept their jobs without need of a government bailout, and the distressed asset purchaser in time earned a return on investment of twenty to thirty times the acquisition price. Three years after the Section 363 sale, the acquiring company went public (and remains so today). Unfortunately, unsecured creditors and the shareholders lost everything because they were not in a position to finance the debtor to see the cycle through. Over time, the price of zinc went from thirty cents to $2 a pound. The Horsehead bankruptcy was enormously successful from the standpoint of a socially positive result.

Ultra Stores Inc.

All Chapter 11 reorganizations are in effect sales. In *Ultra Stores Inc.,* No. 09-11854, 2009 WL 6765451 (Bankr. S.D.N.Y. Dec. 17, 2009), the sale of distressed assets occurred in a traditional reorganization format. In that case, Ultra's junior secured lender, trade creditors, and management formed a coalition to reorganize and refinance the debtor. The senior secured creditor loan was untarnished and was paid in full. One-half of the junior lender's loan was kept in place, and one-half of the loan was swapped into 56 percent of the equity in the reorganized company. The unsecured creditors received notes for approximately 10 percent of their claims plus 18 percent of the reorganized company's equity, and maintained a customer relationship. The debtor's senior management team got a 26 percent sliver of sweat equity in the reorganized company, which vested over four years. The value of the sliver was dependent on the company righting its course over the four-year vesting period. Stores remained open, employees kept their jobs, and landlords kept their tenants. This is exactly the result that bankruptcy reorganizations are intended to achieve.

The bankruptcy statute no longer works for small companies in need of reorganization. The fees and expenses of professionals that a debtor typically incurs in a Chapter 11 case are too high for companies with limited resources. The commencement of a bankruptcy necessitates the filing of monthly operating reports, retention of professionals at many levels, development of a plan of reorganization, preparation of a disclosure statement, objections to claims, prosecution of avoidance actions, and participation at multiple court hearings, all of which the debtor pays for in the form of administrative expenses. The result is fewer traditional small company reorganizations and less money to pay creditors. With the exception of real estate insolvencies, a Chapter 11 makes little sense for a troubled debtor where the value of a company's assets is significantly lower than the claim of a secured creditor holding a blanket lien on the distressed assets.

Benefits of Secured Party Sales

We have found it to be sensible for distressed smaller companies and their secured creditors to pursue a secured party sale of the companies' assets under Article 9 of the Uniform Commercial Code. This asset transfer alternative offers several distinct advantages to Chapter 11. The process can be completed in as little as thirty days. Court approval of the transaction is not required. Professional fees are minimized, and the secured creditor can often obtain cooperation of the borrower necessary to entice buyers, because the debt is usually personally guaranteed by the principals of the company. As part of the Article 9 sale transaction, a resolution of the lender's guaranty can usually be negotiated.

The secured lender must be careful to provide notice of the Article 9 sale to all parties who may claim an interest in the collateral. Since the secured lender controls the terms and conditions of the sale, the law requires it to ensure, and be prepared to prove if challenged, that each aspect of the sale, including the method, manner, time, and place, is commercially reasonable. Buyers at Uniform Commercial Code sales normally do not receive representations or warranties from the seller or the secured lender. Rather, they buy the assets "as is, where is." In addition, such buyers will not receive the comfort and protection of a bankruptcy court order authorizing the sale free and clear of liens, or finding that the purchase price paid is fair and reasonably equivalent to the value of the assets purchased. Buyers will have to make their own assessments as to the risk that others may subsequently attack their purchases as constructively fraudulent transfers, or subject to successor liability for the debts of the borrower.

In smaller insolvencies, we have used the Article 9 Uniform Commercial Code sale rather than the bankruptcy route on multiple occasions. Most recently, it was used successfully for an automotive electronics distributor, and the consensual resolution avoided protracted litigation. The parties were eager to take advantage of the benefits this alternative offers, even though bad feelings and mistrust had infected their relationship. The secured lender was willing to pursue an Article 9 sale because the process facilitated a peaceful surrender of the collateral that could be resold quickly, rather than risk depreciation of inventory in a warehouse while the parties litigated. The borrower's principals dealt with their guaranties, and avoided the stigma of bankruptcy and the entry of judgments against them. In short, the matter was resolved in the least expensive and fastest manner possible.

An Analysis of Distressed Business Transactions

When working on distressed asset transactions, counsel must determine whether a troubled company has a balance sheet issue and/or a business issue. An example of a balance sheet issue is too much debt, while a business issue might be the wrong product in a changing market. In most cases, the two issues are intertwined, and divesting all or part of a business that is no longer profitable may be the only solution.

Building Value through Investing in Distressed Businesses

The distressed arena attracts investors looking to make a significant profit from buying assets at distressed prices. The psychology of the marketplace plays a huge role. In 2006, everybody was euphoric about real estate values, and banks were literally begging people to take mortgage money. Investment banks took individual mortgages, bundled them, and securitized the bundles, which were then offered to investors as Grade A product with little risk and high yield. When the market collapsed, there were no regular buyers, and no credit; the stage was set for the opportunistic buyer.

Essentially, the distressed buyer makes a decision to buy underperforming assets at a price that is less than replacement value. The distressed buyer then finances the asset until the market comes back. This type of decision is driven by the profit motive, but it is in the context of markets that have a tendency to always go too far in either direction—too high or too low. The current real estate market that previously overreacted on the upside, and then overreacted on the downside, is a distressed buyer's version of paradise. The pendulum's swing affords an opportunity for opportunistic financing or purchase. A distressed seller gets rid of an underperforming asset, and the seller's lender sheds a bad loan.

Significant Recent Cases

Attorneys wishing to practice in the troubled asset area should familiarize themselves with three very important recent cases.

General Growth Properties, *Inc.*

Bankruptcy is one of the strategies that even a business that is well run might need to consider for employment in its defensive arsenal. Even companies that are well managed, and have Class A assets, can be bankruptcy candidates when credit markets freeze. For example, *General Growth Properties Inc. (GGP),* 426 B.R. 71 (Bankr. S.D.N.Y. 2010), is a very well-run company. You could argue about whether it was over-leveraged.

However, as the second largest owner of retail malls in the country, it is hard to argue about GGP's success. GGP was severely distressed by its inability to reasonably refund significant portions of its funded debt maturing in a closed credit environment. GGP is a public company, and it serves as the corporate general partner of a limited liability company that owned hundreds of individual properties in individual special-purpose entities. Located in the first tier of the GGP corporate structure was approximately $7 billion of indebtedness that was unsecured and about to be in default if maturing debt traunches could not be refinanced. If GGP defaulted on a single tranche of its funded debt at the parent level, that default would in turn additionally cause defaults at the GGP and individual subsidiary levels, and the snowball effect would continue throughout the corporate structure. A bankruptcy filing was needed to safeguard GGP's assets.

GGP's individual properties were the subject of discrete mortgage debt within the special-purpose entities. Immediately after GGP filed, several lenders brought actions against the debtors asserting that the special-purpose entities were filed in bad faith. The lenders maintained that the removal by GGP of special-purpose entity independent directors was illegal and that the bankruptcy filing was thus in bad faith.

The judge disagreed, noting that directors have specific shifting duty—when the enterprise is in trouble, the duty shifts from taking care of discrete interests to taking care of a much larger constituency. See *In re Gen. Growth Props. Inc.*, 409 B.R. 43, 61 (Bankr. S.D.N.Y. 2009). The court held that the removal of the directors was not done in bad faith, even though the assets of the company were pledged, so long as the loan was being serviced and the property was being maintained. Even though the subsidiaries were separate entities with separate secured lenders, the judge recognized that there *was an identity of interest* in place with regard to the entire GGP enterprise. The court ignored the special-purpose entity framework and recognized the identity of interest in the whole as being paramount. What came next was a brilliant reorganization of the special-purpose entity properties, or a bankruptcy within a bankruptcy. GGP created and confirmed a bankruptcy plan for all of the subsidiaries at the operating level, negotiated relief from the automatic default attendant to GGP parent debt default, extended specific mortgage loans, and thus set the stage for the GGP parent to deal with its own debt obligation issues.

Pacific Lumber

The Fifth Circuit Court of Appeals in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), confirmed a reorganization plan that cashed out the secured lender at an amount equal to the value of the creditor's collateral as determined by the bankruptcy court, and denied the secured creditor permission to credit bid its claim in connection with a sale of the collateral under a plan. Without ruling on whether the right of a secured creditor to credit bid is absolute, the bankruptcy court denied the lender's attempt to credit bid because it was untimely in the context of the debtor's plan process. Most importantly, the circuit court, in upholding the bankruptcy court's denial, ruled that a cash payment under a plan involving the sale of collateral belonging to a secured lender constituted the *indubitable equivalent* of the secured lender's claim. Prior to *Pacific Lumber*, it was thought that the only way to prohibit a secured lender's credit bid at such a sale was "for cause" such as bad conduct, or to foster a competitive bidding environment. *Pacific Lumber* paved the way for the *Philadelphia Newspapers* case.

Philadelphia Newspapers, LLC

In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the Third Circuit Court of Appeals ruled on the issue of whether a secured creditor enjoyed an absolute right to credit bid in the context of a Chapter 11 plan that offered to pay the secured lender cash in an amount equal to its court-determined collateral value in full settlement of the lender's lien claim, even though the lien claim totaled far more than the total dollar amount of the collateral value payment. Responding to the issue of what is necessary to satisfy the rights of a secured lender, the court said that a secured lender does not have a right to credit bid for assets being sold under a plan so long as the secured creditor receives the indubitable equivalent of its loan. The court interpreted "indubitable equivalent" to be the evidenced (to the court) cash value of the lender's collateral. The ruling, if followed in other circuits, may prove to be monumental and will have an enormous impact on buyers of distressed assets. For example, suppose that a building has a secured loan of $20 million, but the building is worth only $10 million. A plan that pays the lender $10 million in cash can eliminate the lender's ability to credit bid its loan in connection with the building's sale. Until *Philadelphia Newspapers* and *Pacific Lumber*, most experienced bankruptcy practitioners would have opined that the secured lender in this example would have an absolute right to credit bid its $20 million debt to attempt to retain its collateral. Thus, prior to *Philadelphia Newspapers* and *Pacific Lumber*, a distressed asset buyer could purchase the loan from the bank with the confidence of knowing it had bidding power of $20 million; that confidence no longer exists.

Strategies for Structuring Distressed Asset Transactions/Secured Lenders

Due diligence is important when working on distressed asset transactions. You have to understand the assets and business, as well as the macro business and economic climate. A key element in all of this is tax planning, and every transaction needs to be reviewed in the context of its tax consequences. For example, if a party is seeking to sell an asset that is subject to a debt obligation of $20 million to a new buyer for $10 million, the transaction will take place because the secured lender, in an effort to encourage the debtor to make that transaction, forgives $10 million. If not done correctly, that forgiveness may produce cancellation of indebtedness income. Every deal related to distressed assets must be examined in terms of the deal's tax implications. Quite often, a bankruptcy may be mandated for no reason other than to avoid prohibitive taxes of cancellation of indebtedness income.

Advice for Practitioners

Learn your craft, watch the case law, and understand the business of the troubled business. Most likely, the recent cases described above will be expanded upon in the next few years. Attorneys wishing to be effective in the distressed asset marketplace must understand the entire range of possibilities when dealing with distressed assets. When companies are in distress, opportunity knocks.

Key Takeaways

- Carefully consider the efficacy of a distressed asset transaction from both a societal perspective and the waterfall of entitlement mandated in bankruptcy; query whether, if shareholders and unsecured creditors receive little or no value, there is yet an opportunity to save people's jobs.

- When analyzing a company's situation, start with broad issues before focusing on the company's specific problems.
- Determine whether the company is struggling due to a balance sheet issue (too much debt) or a business issue (wrong product, wrong market).
- Examine the tax implications of a case to determine the best strategy to minimize the impact of asset transfers to new owners.
- Understand the full complement of options available for financing a distressed asset transaction, including bank or bond debt.

Related Resources

- *In re Gen. Growth Props Inc.,* 409 B.R. 43 (Bakr. S.D.N.Y. 2009)
- *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009)
- *In re Philadelphia Newspapers LLC*, 599 F.3d 298 (3rd Cir. 2010)
- Uniform Commercial Code Article 9: 11 U.S.C. § 363 (2010)

Joshua J. Angel is senior counsel in Herrick, Feinstein LLP's Restructuring and Bankruptcy Group. He has forty-eight years of experience in bankruptcy and corporate restructuring matters, representing debtors, creditors, shareholders, class action plaintiffs, and acquirers of assets from debtors. He advises in out-of-court restructurings of financially distressed businesses or people and entities seeking to acquire such businesses or their assets. He is recognized as a leading member of the New York Bankruptcy Bar and has served as the lead debtor's counsel in some of the bankruptcy court's most significant cases.

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