How To Handle Corporate Distress Sale Transactions

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A. Introduction

1. Recent economic conditions have increased the number of distressed companies that are seeking to sell assets as part of their plans to improve their financial condition. These distress sale situations can present both significant risks and significant opportunities for potential buyers.

2. To make the most of these situations, buyers need to be skilled in spotting distressed sellers and conducting the acquisition process in a manner that minimizes those risks and maximizes those opportunities. As discussed below, chapter 11 provides both buyers and sellers with tools that will help them make the best of a distressed merger and acquisition transaction.
B. Identifying the Distressed Seller

1. *Signs of Distress.* The filing of a bankruptcy petition is not the only sign of distress. Others include:

   a. Recent ratings downgrades, which may trigger defaults under financing arrangements and limit access to commercial paper markets and cause turmoil with suppliers, who may be unwilling to continue to extend credit;

   b. Near-term scheduled expiry of credit facilities, which may cause liquidity concerns and unusual cash-preserving behavior;

   c. A complex capital structure, dominated by multiple affiliated issuers of multiple issues of public debt with covenants limiting the granting of liens, asset sales, and other fund-raising activities, all of which may lead to liquidity problems;

   d. The pendency of significant regulatory investigations or decisions, which may trigger (or increase) class actions or shareholder derivative actions;

   e. Indications of discord with auditors or expectations of qualified accountant’s opinion;

   f. A shift in lender representatives, such as a change in the lender personnel responsible for dealing with the borrower or the retention of professionals;

   g. Debt reduction programs, such as asset sales and equity offerings;

   h. Cost reduction initiatives, such as layoffs, pursuit of union concessions, and rationalization of, or exit from, certain business lines; and

   i. Unexpected changes in senior management, especially in those with responsibility for financial matters.

C. Risks of a Distressed Transaction Without Chapter 11

1. Real risks attend a distressed transaction outside Chapter 11:

   a. *Fraudulent conveyance or transfer claims.* The parties may be exposed to fraudulent conveyance and transfer claims.
b. **Shifting fiduciary duties.** The fiduciary duties of seller’s officers and directors will shift as the seller approaches insolvency, potentially creating confusing and inconsistent negotiations. (The fiduciary duties of directors and officers of an insolvent company include a duty to all creditors. See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (when a corporation is close to insolvency, the directors owe fiduciary duties not only to its shareholders, but to the entire corporate enterprise, including its creditors); *Geyser v. Ingersoll Publications Co.*, 621 A.2d 784, 789 (Del. Ch. 1992) (“The existence of fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when the shareholders’ wishes should not be the directors’ only concern.”).

c. **Due diligence complications.** Due diligence may be especially challenging because the seller may be attempting to minimize or hide its problems.

d. **The seller may seek bankruptcy protection.** The seller may file for bankruptcy protection (or be the subject of an involuntary filing) after a purchase agreement has been signed or after the transaction has closed. Once a bankruptcy petition has been filed, the purchase agreement can be rejected by the seller.

D. **Chapter 11 Sales**

1. In contrast, an asset sale in the context of a chapter 11 proceeding will mitigate the risks identified above and provide both the buyer and the seller with a variety of other substantive and procedural benefits.

2. **Process Overview.** An asset sale by a chapter 11 debtor occurs as either a sale of assets other than in the ordinary course of business under section 363 of Title 11 of the United States Code (the “Bankruptcy Code”) (a “Section 363 Sale”) or under the debtor’s plan of reorganization (a “Plan Sale”). Although both of these procedures are described below, the balance of this outline will focus on Section 363 Sales, which are usually preferable to Plan Sales and appear to be more common in current practice.

3. **Section 363 Sales.**

   a. Section 363 Sales permit debtors to sell assets outside of the plan confirmation process, thus potentially disenfranchising stakeholders. As a
result, bankruptcy courts will require a sound business purpose for the use of section 363 and a strong showing that a sale outside of the plan confirmation process is justified. See In re Industrial Valley Refrigeration and Air Conditioning Supplies, Inc., 77 B.R. 15, 21 (Bankr. E.D. Pa. 1987) (stating that the requirements for a Section 363 Sale include accurate and reasonable notice, a showing that the price to be paid is adequate, fair and reasonable, and a showing of good faith, e.g., the absence of lucrative insider deals); In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) (stating that a bankruptcy judge must consider all the salient factors of the proceeding to determine if a sound business purpose exists, including “the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value”).

b. The most common justifications for a Section 363 Sale, which is typically much faster than a Plan Sale, are that the value of the assets involved will rapidly deteriorate or that the seller urgently needs the cash from the sale to continue its remaining businesses and avoid a liquidation, which, in either case, will lead to a lower recovery by creditors. See, e.g., In re Trans World Airlines, Inc., et al., No. 01-00056(PJW), 2001 WL 1820326, at *4 (Bankr. D.Del. Apr. 2, 2001) (“TWA had no other strategic transaction available to it and had no other offer for value to which it could turn. Nor could TWA rely on its self-help plan because TWA was unable to procure adequate capital infusion to implement that plan. Its only alternative was a free fall chapter 11 filing with the high likelihood of a piecemeal liquidation of the enterprise.”).

c. A Section 363 Sale typically begins with the selection of a “stalking horse” purchaser who has entered into an agreement to purchase the assets in question. The stalking horse deal is then subjected to a bankruptcy court-sponsored auction conducted in accordance with bidding procedures agreed between the seller and the stalking horse and approved by the Bankruptcy Court. The objective of the auction process is to obtain the “highest and best” offer for the assets, thus maximizing the proceeds to the estate and, indirectly, the seller’s creditors. See, e.g., In re Abbotts Dairies of PA, Inc., 788 F.2d 143, 149 (3d Cir. 1986) (stating generally that “an auction
may be sufficient to establish that one has paid ‘value’ for the assets of a bankrupt”); *In re Food Barn Stores, Inc.*, 107 F.3d 558 (8th Cir. 1997) (discussing bidding procedures and their importance in maximizing the value of the estate). Note that “highest and best” includes non-monetary considerations such as certainty and speed of closing. Once the winning bidder is selected, the bankruptcy court conducts a sale hearing and, absent successful objections, enters an order approving the sale.

4. **Plan Sales.** Sale of assets occurs as part of the seller’s plan of reorganization and must therefore be approved under the plan confirmation process: approval of a plan of reorganization requires the approval of the bankruptcy court and holders of two thirds in amount of claims and a majority in number of each class of impaired creditors and, in some cases, two thirds of voting stockholders. *See* 11 U.S.C. §1126. A plan can also be confirmed under the Bankruptcy Code’s “cramdown” provisions. *See* 11 U.S.C. §1129(b). Except in the case of pre-packaged plans, this process typically takes significantly more time than a Section 363 Sale.

E. **Advantages of Chapter 11 Sales**

1. **Buyer’s Perspective.**

   a. The buyer takes the assets free and clear of all liens, thus permitting the buyer to assume with certainty only specified liabilities. (According to section 363(f) of the Bankruptcy Code, property may be sold “free and clear of any interest in such property of an entity other than the estate, only if—(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.” Adequate notice of the proposed sale is also a condition to a sale free and clear. *See, e.g.*, *Folger Adam Security, Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252 (3d Cir. 2000).) For example, historical liabilities such as employee legacy costs, environmental liabilities, tax liabilities and litigation can be left behind. (Prospective buyers should, however, be aware of the risks of potential successor liability claims. *See, e.g.*, *In re Savage Industries, Inc.*, 43 F.3d 714, 720 (1st Cir. 1994).)

   b. Bankruptcy Court approval should bar fraudulent conveyance and transfer claims and should ensure the enforceability of the purchase docu-
c. The dynamics of the situation may permit the buyer to pick and choose assets and liabilities with more latitude than would be typical outside of bankruptcy. The seller’s creditors will have a stronger voice in the process and may care less about requiring a buyer to take all liabilities associated with the purchased business, especially if those liabilities are primed by those creditors’ claims.

d. Buyers will also have great flexibility in assuming contracts related to the assets being purchased. As a general rule, section 365 of the Bankruptcy Code permits a debtor to assume and assign its contracts as it sees fit, regardless of explicit or de facto restrictions on assignment, provided that: (1) the contract is executory in nature, (2) past defaults are cured, usually by the payment of money damages, and (3) adequate assurance of future performance by the assignee is given. Section 365 does not permit the assumption and assignment of: (1) a contract that may not be assigned under applicable law, e.g., personal service contracts, which some courts have found to include government contracts, see, e.g., In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988), and patent licenses, see, e.g., In re CFLC, 89 F.3d 673 (9th Cir. 1996); (2) contracts to provide financing to or issue securities of the debtor; or (3) nonresidential leases that have terminated under applicable nonbankruptcy law. Contracts that are not assumed and assigned can be rejected. Section 365 provides the buyer with enhanced leverage in dealing with contract parties, who may be willing to make compromises in order to avoid having their contracts rejected.


g. State law shareholder approval requirements and bulk sales laws are inapplicable.
h. Buyers have protection in the event they desire to provide interim financing to their sellers. These loans can be granted priority over pre-petition claims, can be applied towards the purchase price if the buyer prevails, and can require that they be repaid in connection with the consummation of a transaction with a different buyer.

2. Seller’s Perspective.

a. Because the buyer will take the assets free and clear, the seller can take the position that they are being sold “as is.” The practical effect of this is that the seller (and its creditors) can argue for limited representations and warranties that will not survive closing.

b. With Bankruptcy Court approval of the transaction, the seller’s officers and directors will be insulated from post-closing attacks based on breach of fiduciary duty claims. See, e.g., In re Industrial Valley Refrigeration and Air Conditioning Supplies, Inc., 77 B.R. 15 (Bankr. E.D. Pa. 1987). This is especially valuable in an insolvency setting, where fiduciary duties may be hard to define.

c. The asset transfer may be exempt from stamp and similar transfer taxes. See In re Hechinger Inv. Co. of Del., Inc., 276 B.R. 43 (D. Del. 2002) (holding that pre-confirmation sales of realty were exempt from transfer and recording taxes as the transfers were an essential component of plan confirmation); In re GST Telecom, Inc., 2002 WL 442233 (D. Del 2002) (construing “under a plan” in section 1146(c) to include transfers made in anticipation or contemplation of a plan); But see In re NRV, L.P., 189 F.3d 442, 458 (4th Cir. 1999), cert. denied, 528 U.S. 1117 (2000) (holding that only transfers taking place after plan confirmation are entitled to the exemption under 1146(c)).

d. Chapter 11 will provide the seller with much more control over the sale process. With the protection of the automatic stay, in most cases the seller will be free to conduct, with the Bankruptcy Court’s supervision, a relatively orderly auction of its assets.

F. Key Process Points

1. Preliminary Agreements.

a. Confidentiality agreements. Buyers should avoid blanket prohibitions on disclosure of the existence of discussions or the terms of a proposed trans-
action to preserve their ability to promote their transactions to the seller’s creditors and perhaps collaborate with other bidders. (In this regard, buyers should be aware of section 363(n) of the Bankruptcy Code, which provides that if a Section 363 Sale price “was controlled by an agreement among potential bidders,” the trustee or debtor can avoid the sale or recover any excess consideration, can recover its costs, and can seek punitive damages. Courts have incorporated a bad or corrupt intent requirement into this provision. See In re New York Trap Rock Corp., 42 F.3d 747, 752 (2d Cir. 1994) (holding that section 363(n) is designed to preclude only covert agreements that are intended to control price and thereby deprive the estate of fair value for its assets).

b. Standstill agreements. Sellers should seek standstill agreements that will prohibit potential buyers from purchasing claims against the seller. Without a claim, a disgruntled buyer may not have standing to object in the Bankruptcy Court to the sale process. (An unsuccessful bidder in a Section 363 Sale usually lacks standing to challenge a Bankruptcy Court’s approval of the transaction or the bidding process, except when challenging the “intrinsic fairness” of the sale process. See In re Colony Hill Assoc., 111 F.3d 269, 273 (2d Cir. 1997) (stating that under the “aggrieved person” standard for appellate standing an unsuccessful bidder whose only loss is speculative profits from the property auctioned, in the absence of fraud, mistake or unfairness, usually lacks standing to challenge the sale); See also, In re Gucci, 126 F.3d 380, 388 (2d Cir. 1997).) Buyers should require, at a minimum, a “most-favored nation” provision that would loosen the standstill and other restrictions to the extent they are loosened for others. This will discourage the seller from offering special arrangements to favored buyers, such as insiders.

c. Exclusivity agreements. Exclusivity arrangements are of dubious value in the chapter 11 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. See, e.g., In re Big Rivers Elec. Corp., 233 B.R. 739, 752 (W.D.Ky. 1998) (finding a “no-shop” clause invalid because it prevented the debtor from “initiating, soliciting, or negotiating offers and proposals for the sale or lease of its assets” which may have brought in greater value to the estate). 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 be difficult to get.
2. *Due Diligence.* For a number of reasons, due diligence is especially important in a chapter 11 sale.

   a. The seller’s distressed situation may have caused its management to take aggressive or unusual measures in operating the business, such as using working capital in peculiar ways or deferring maintenance or capital expenditures. In some cases, there may have been fraud. A careful and skeptical due diligence investigation will be necessary to discover and understand the true nature of the business being sold.

   b. There may be no post-closing indemnification for breaches of representations and warranties. Although the buyer will take the assets free and clear of liens, there may be defects or unusual circumstances that only thorough due diligence will uncover.

   c. Due diligence is key to understanding the assets and liabilities the buyer is willing to purchase and may permit the buyer to create a menu of options from which the seller can choose the transaction that best suits its goals. This flexibility may give the buyer an advantage over other buyers.

3. *Stalking Horse Decision.* The buyer needs to decide whether it is willing to serve as the stalking horse.

   a. Pros.

      i. Guaranteed opportunity to make a bid in the unlikely event an auction isn’t held;

      ii. Key role in formulating minimum parameters of the deal and the bidding procedures;

      iii. Bidding procedures should compensate the stalking horse in the event another buyer prevails; and

      iv. Allows the buyer to highlight any unique aspects of its offer or other competitive advantages.

   b. Cons.

      i. It may be difficult to negotiate the stalking horse agreement, because of the distressed nature of the seller and the multiplicity of decision makers;
ii. The bidding procedures may be challenged and the stalking horse may not be made whole if another buyer prevails; and

iii. The stalking horse’s bid may prove to have been too rich, especially when there is a rapidly growing glut of a certain type of assets becoming available.

4. *Purchase Agreement*. The purchase agreement for a chapter 11 sale is typically quite similar to a non-bankruptcy purchase agreement, with the following exceptions:

a. There will be detailed provisions describing the bankruptcy process, including the proposed bidding procedures and each party’s required actions.

b. 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 shut-down costs. Items that would have been administrative claims are particularly noteworthy because they would have been paid before prepetition claims. (Section 363(k) of the Bankruptcy Code permits a buyer to offset against the purchase price the amount of any claims it may have against the property being purchased. Although the value of such a claim arguably should be discounted on account of the seller’s bankruptcy, the buyer will get credit for the full amount of the claim and thus may get a competitive advantage against other bidders.)

c. 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, this agreement is predicated on estimates of cure costs and will specify what happens if a cure cost is ultimately determined to exceed the estimate. For example, a seller might agree to pay cure costs up to the amount of the estimate; if the cure cost exceeds the estimate, the buyer can choose to either pay the excess or direct the seller to reject the contract. As noted below, the final determination of cure costs may not occur until after the closing.
d. There will likely be fewer representations and warranties and limited post-closing indemnification for breaches of those representations and warranties.

e. There may be fewer post-closing covenants 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.

f. There may be fewer conditions to closing because in most cases the Bankruptcy Code nullifies things like shareholder and contract party consents.

g. 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.

5. **Bidding Procedures.** The bidding procedures, which will be subject to challenge by the seller’s creditors, will include some or all of the following:

   a. A definition of who will be permitted to bid (a “qualified bidder”) and the minimum requirements for a bid to be considered (a “qualified bid”). Typical qualified bidder criteria include:

      i. The execution by the bidder of the seller’s form of confidentiality agreement and convincing evidence of financial wherewithal. A “qualified bid” could require a significant cash deposit, that the scope of the bid be substantially equivalent to the scope of the stalking horse bid, a signed purchase agreement (including final schedules, which may be very difficult to prepare), no financing or other non-regulatory conditions, no breakup fees, and stiff overbid requirements.

   b. A bid deadline and proposed auction date. Not surprisingly, the buyer will want the bid deadline and auction to be as soon as possible, while the seller will want them to be relatively distant to facilitate robust bidding activity. Stalking horses will also want to ensure that there will be enough time between the bid deadline and the proposed auction date in order to permit them to assess competing bids and be in a position to improve their initial bids at the auction. Stalking horses should also attempt to limit the seller’s ability to extend the bidding deadline and should require the seller to cancel the auction and present the buyer’s bid to the bankruptcy court for approval if no qualified bids are received by the bid deadline.
c. **Overbid requirements and minimum bidding increments.** Overbid requirements require bidders to exceed the stalking horse bid by a specified amount. This amount is usually in excess of the stalking horse’s break-up fee to insure that the bid will actually provide the seller with more consideration, after payment of the break-up fee, than the stalking horse bid. Bidding increments govern subsequent bids by either requiring that each subsequent bid must exceed the preceding bid by a specified amount or must provide the seller with a minimum increment of additional consideration over the preceding bid, the difference between these two approaches being whether you consider the effect of the break-up fee in assessing whether the increment has been met. The stalking horse could also seek the right to match any other bids.

d. **Criteria for determining which bid is the highest and best.** If the stalking horse does not succeed in limiting qualified bids to the same set of assets and liabilities as the stalking horse is purchasing, the buyer may insist that the bidding procedures specify the manner in which the seller must allocate consideration to certain assets in order to facilitate the comparison of bids for different sets of assets and liabilities. Buyers may also want the bidding procedures to include rules that specify how the seller must value different forms of consideration. For example, these rules might state that non-public securities should be ascribed no, or a significantly discounted, value, while cash would of course be valued at face value. The buyer would attempt to construct these rules to favor its form of consideration over other forms of consideration.

e. **A break-up fee.** Bidding procedures often provide that the stalking horse bidder will receive a break-up fee (sometimes with an additional expense reimbursement) if it ultimately loses the deal to another bidder. The break-up fee is intended to compensate the stalking horse for its expenses and lost opportunity costs. Generally, courts will uphold break-up fees below three percent of the purchase price. See *In re Hupp*, 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992). This aspect of the bidding procedures is often the most controversial one because it can be viewed as a windfall to the stalking horse and as guaranteed to chill bidding. To be approved, break-up fees must be designed to enhance the bidding process and must be reasonable. (Depending on the court, break-up fees are assessed by application of the business judgment rule, see *In re Integrated Resources, Inc.*, 147 B.R. 650 (S.D.N.Y. 1992), or the best interest of the estate test. See *In re S.N.A. Nut Co.*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995). Unsuccessful initial bidders may
also seek to recover expenses related to due diligence and preparing the
initial bid as administrative expenses entitled to priority under section 503
of the Bankruptcy Code. See, e.g., In re O’Brien Environmental Energy, Inc.,
181 F.3d 527 (3d Cir. 1999) (break-up fees denied because party failed to
establish that break-up fees were necessary to preserve the value of the
debtor’s estate pursuant to 11 U.S.C. §503(b)(1)(A).)

f. Auction rules. A wise bidder will endeavor to include in the bidding pro-
cedures a clear timetable and set of rules to govern the auction at which
the winning bidder is selected.

6. Auction, sale hearing and sale order. At the auction, qualified bidders will have
the opportunity to bid against each other, subject to the bidding procedures.
Once a winner is selected, the bankruptcy court will hold a hearing to con-
sider the proposed sale and, if it is approved, enter an order stating so and
authorizing the seller to consummate the transaction. The sale order should
include several key provisions:

a. The sale order should state: that the seller has advanced sound and suffi-
cient business reasons for, and has reasonably exercised its business judg-
ment in determining to enter into, the proposed sale; that the proposed sale
was negotiated in good faith, without collusion, and constitutes the high-
est and best offer for the assets; and that, therefore, the sale is approved.

b. The sale order should state that: the assets are being sold free and clear of
all claims; that the buyer will have no liability as a result of the sale other
than liabilities that are specifically assumed; that the buyer is a “good faith
purchaser” within the meaning of section 363(m) of the Bankruptcy Code;
and that the sale order will be effective immediately, without the ten-day
stay otherwise imposed by Bankruptcy Rules 6004(g) and 6006(d). These
last two items will protect the buyer against an appeal of the sale order,
even if that appeal results in the reversing of the sale order.

c. The sale order should approve and ratify the bidding procedures and the
seller’s conduct of the bidding process. (In the absence of fraud, unfair-
ness, or mistake at a judicial sale, a court is not likely to upset the results
of the sale. See In re Food Barn Stores, Inc., 107 F.3d 558, 564 (8th Cir. 1997).
On the other hand, a court will be mindful that the primary objective in a
bankruptcy sale is to maximize the value of the estate. See id. at 565. “To
summarize, we think that the important notions of finality and regularity
in judicial auctions are are appeased if the court acts consistently with the
rules by which the particular sale is conducted and in compliance with the
bidders’ reasonable expectations.” Id.)

d. The sale order should provide a process for the assumption and assign-
ment of the contracts the parties have agreed will be conveyed to the
buyer. This process is usually begun by the seller filing an assumption
notice that identifies the contracts the seller desires to assume and assign
and the proposed cure amounts for those contracts. The assumption notice
is served on the contract parties, who will have a specified period in which
to object to the proposed assumption and assignment or the proposed cure
amount. If there are no objections with respect to a particular contract,
upon payment of the cure amount, it will be conveyed to the buyer, usu-
ally effective as of the closing date. If an objection is received, it will be set-
tled either by the agreement of the parties or by the bankruptcy court,
although buyers and sellers should endeavor to retain flexibility (and the
corresponding leverage) to reject contracts as to which objections are filed.

G. Conclusion

1. Chapter 11 provides buyers and distressed sellers with a number of substan-
tive and procedural benefits. These include ways to minimize post-closing
uncertainty and provide a measure of order to what may otherwise be a chaot
situation.

2. To take advantage of these benefits, however, buyers and sellers alike must be
skilled at both identifying the signs of distress that often foreshadow a chap-
ter 11 filing and working within the sale process provided by chapter 11.