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Distressed M&A: Considerations Amid a Pandemic

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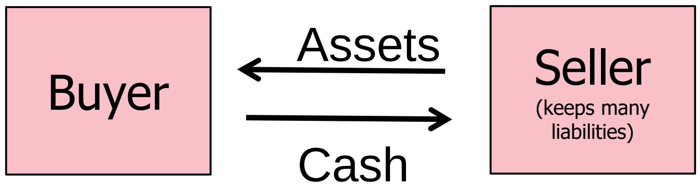
LEGAL ISSUES

Successor Liability

- The most common structure for the acquisition of a distressed company is for the purchaser to pay cash for the seller's assets, but not assume any of the seller's liabilities (other than the specific liabilities agreed to in the Asset Purchase Agreement ("APA")).



- As a general rule, a purchaser of assets is not liable for the liabilities of the target that are not specifically assumed. This is unlike acquisitions of stock or a merger where the target retains its liabilities.

Successor Liability

- However, there are a number of exceptions to the general rule:
  - Express or implied assumption of liabilities
  - De facto merger
    - Continuation of enterprise (e.g., continuity of management, personnel, physical location, assets, general business operations)
    - Continuity of ownership
    - Seller ceasing its business operations
    - Buyer assuming liabilities and obligations of seller that would be necessary for the uninterrupted continuation of the business
  - Fraud (based on doctrine that transactions entered into solely for purpose of escaping liability should not be permitted)
  - Product-Line Exception (only a few states)
  - Liability imposed by statute (e.g., CERCLA, tax, bulk sales laws, etc.)
- These exceptions need to be considered when structuring and documenting an acquisition

Fraudulent Conveyance

- Fraudulent Conveyance
  - Actual Fraud
    - Transfer can be avoided if made "with the actual intent to hinder, delay or defraud" creditors.
    - Typically not a major concern for arms'-length transactions with third parties
    - Badges of Fraud
  - Constructive Fraudulent Conveyance
    - Transfer can be avoided if transferee received less than "reasonably equivalent value" and was insolvent or rendered insolvent as a result of the transaction.
    - Reasonably Equivalent Value
      - What were assets worth and what was consideration received
      - Best evidence is a robust marketing process (avoids expert battle)
    - Insolvency tests
      - Balance sheet insolvency
      - Inability to pay debts as they come due
      - Unreasonably small capital

Fraudulent Conveyance

- Statutes of Limitations
  - Two-years under bankruptcy code
  - State law typically four years (although some longer)
  - Discovery rule can extend limitations period under state law
  - "Golden Creditor"
- Transactions at risk
  - Asset sale where seller subsequently files for bankruptcy
  - LBO
- Remedies
  - Payment of additional purchase price
  - Unwind of transaction

Fiduciary Duties of Target Company Directors

- In a financially healthy corporation, directors & officers owe fiduciary duties to shareholders
- When a corporation is insolvent, duties expand and directors must consider the interests of creditors
  - If the corporation is insolvent and is liquidated, then the shareholders ultimately will have no economic interest and no recovery
  - Courts thus recognize creditors as being an additional constituency to whom duties are owed as residual (and often sole) beneficiaries of the value of the corporation
- Tests for insolvency:
  - Liabilities exceed assets (balance sheet test); or
  - Inability to pay debts as they come due (liquidity test)
- Law is evolving on whether duties can be waived in the context of an LLC
- Practically speaking, what does this mean for directors?

Distressed Sales in the Time of COVID-19

- Out of court options – people want to get deals done swiftly and cheaply
  - Speed and efficiency
  - Saving on expenses – throwing good money after bad
- Lenders and other constituents have less of an appetite to finance the more expensive process – bankruptcy
- Other concerns that could weigh on fiduciary obligations of directors and officers
  - Job preservation
  - Businesses performing essential functions
  - Exhaustion of PPP funds

OUT-OF-COURT TRANSACTIONS

Structuring Out-of-Court Transactions

- Out-of-court transactions of distressed companies can be structured like any other acquisition, but they are most often structured as asset acquisitions where all liabilities not specifically assumed are left with the seller.
  - Specific enumeration of assumed liabilities is typical
  - Indemnification for excluded liabilities (but consider whether there is adequate recourse)
  - Due diligence is key to assessing and pricing risk
- The goal is to leave behind many of the liabilities that resulted in the company becoming distressed.
  - Some liabilities (environmental, multiemployer pension, etc.) pose special challenges
  - State law "ABC" process can sometimes be helpful – or create problems (differs by State and fact pattern)
  - Problems with out-of-court sales include inability to assign contracts/leases without consent, no court oversight, no automatic stay and inability to sell "free and clear" of secured and other claims.

Advantages of Out-of-Court Transactions

- Usually the fastest and cheapest option
- Avoid potential negative effects of a bankruptcy on a seller's relationships with customers, suppliers, and employees
- Buyer may be able to protect itself from successor liability through insurance
- COVID Consideration – in this environment, it may be preferable to avoid having to rely on a court's schedule, particularly in jurisdictions that are not as willing to use electronic technology

Disadvantages of Out-of-Court Transactions

- Does not convey the assets “free and clear” by court order, as a bankruptcy sale would do
- No ability to bind non-consenting creditors
- No ability to remedy agreements that are in default
- No ability to override anti-assignment clauses in leases, licenses and contracts
- No assurance that the transaction will keep the target out of bankruptcy court. Creates substantial risk of successor liability and fraudulent conveyance claims
- “Falling Knife” issue – the range of risks presented may make it very difficult to attract a buyer for a sale structured out-of-court
- There are certain instances where an out-of-court deal is not possible
  - For example: a company that needs to shed contracts or liabilities

Other Potential Considerations

- The seller may not be able to provide post-closing transition services or satisfy other post-closing obligations.
- The seller may not be able to provide post-closing indemnification.
- Even if the seller agrees to provide indemnification, post-closing agreements could be rejected in a subsequent bankruptcy of the seller or seller will not have sufficient resources to satisfy such obligations or the obligations will give rise to mere general unsecured claims receiving little or no distribution in a bankruptcy.
- The seller may have deteriorating relationships with key customers, suppliers, and employees.


363 SALES

What Is a "363 Sale"?

- A "363 Sale" gets its name from Section 363 of the Bankruptcy Code, which governs the sale of property of a debtor.
- Commonly refers to the sale of substantially all of the assets of a debtor in bankruptcy outside the context of a confirmed plan of reorganization.
  – Purchaser takes assets free and clear of all liens and claims (subject to certain exceptions), pursuant to a bankruptcy court order.
- COVID-19 Considerations: Will it be a buyer's market with depressed pricing? Will there be new players in the market who were priced out before, but may not be now?

363 Sale Requirements

- Standard for approving 363 Sales:
  - There must be a “good business reason” for the proposed sale (*In re Lionel Corp.*)
  - Interested parties must be provided with adequate and reasonable notice and opportunity to object
  - The purchaser must be acting in good faith
  - The sale price must be fair and reasonable
- Bankruptcy courts have concluded that the marketplace is the best indicator of the enterprise value of a debtor. Therefore, most 363 Sales occur through a public auction process in order to satisfy the “fair and reasonable” price requirement.
- COVID-19 Considerations: in this environment, parties are going to be interested in deals that are faster and cheaper.
  - What court will a company file in?
  - How will the 363 sale be structured?
  - How can the 363 process be condensed?

363 Sale Process

- A 363 Sale is typically a two-phase process.
- First Phase:
  - The debtor is privately marketed to potential buyers.
  - A "stalking horse" bidder is chosen and a definitive purchase agreement is negotiated and signed.
    - As compensation for setting the initial price and terms, the stalking horse bidder receives bid protections in the event that it ultimately loses at auction, including a break-up fee (typical range is up to 3.5%) and expense reimbursement (usually capped at a fixed dollar amount).
    - Any break-up fee is typically covered by the required "overbid," or amount by which the initial counteroffer must exceed the stalking horse bid.
    - Stalking horses usually must have no remaining diligence conditions to qualify for a breakup fee.
    - Stalking horse APA is binding, but conditional on bankruptcy court approval after bidding process and auction
- COVID-19 Considerations: there may be fewer parties willing to serve as stalking horse, which could mean better than typical bid protections for those that do

363 Sale Process

- Second Phase:
  - Bid procedures are enacted by the court, which typically provide the following:
    - a diligence period, a bid deadline, rules and qualifications to become a qualified bidder, an auction date, and rules for an auction including overbid amounts
  - The stalking horse bidder may seek financing or regulatory approval during second phase.
  - An auction is held and highest and best bidder is chosen
    - Chosen by Debtors typically in consultation with key creditor constituents
  - A second hearing occurs to seek approval of the sale, at which the seller presents to the bankruptcy court the highest and best offer received, and seeks final approval to proceed with the sale.
- The transaction usually closes shortly after approval by the bankruptcy court, subject to waiver of 14-day stay period by the bankruptcy court and willingness to proceed to closing prior to expiration of appeal period.
- Note: Especially in this environment, a debtor may not be successful in getting a stalking horse, in which case the debtor will accept bids and go straight to an auction
- COVID-19 Considerations:
  - Compressed timelines and potential impact of suspensions on sale process
  - Private sales?

Advantages of 363 Sales

- Protections provided under sale order, including:
  - The purchaser acquires assets free and clear of all claims and liens.
  - Sale orders typically contain provisions limiting successor liability claims and finding consideration fair and reasonable which precludes fraudulent transfer claims.
  - Providing notice (either actual or publication notice) of the sale is critical to bind creditors to the free and clear aspects of the sale order.
- Less complex and faster than the plan confirmation process
- Most contracts are assignable despite non-assignment clauses
- Ability to "cherry-pick" assets and liabilities
- Secured creditors can credit bid their debt
- May generate more value for a seller than an out-of-court transaction because the buyer has less risk on a number of issues
- Certain liabilities may follow the assets notwithstanding the bankruptcy court's free & clear order, e.g., certain ERISA/COBRA obligations

Disadvantages of 363 Sales

- A public auction is generally necessary
- Certain tax attributes may be lost, e.g.:
  - NOLs
  - Capital gains on assets being sold may impact distribution waterfall, cutting out entire classes of stakeholders
- Transfer taxes and HSR Act requirements cannot be avoided
  - But note accelerated HSR waiting period for 363 transactions
- As compared to out-of-court transactions:
  - Sale must be approved by the bankruptcy court
  - Notice must be provided to all interested parties
  - Sale is subject to objections
  - Can be more expensive and time consuming (typically 60-90 days but can be shortened for “cause”)
- Debtors typically prefer a plan because of ability to get releases.


OTHER ACQUISITION
APPROACHES

Acquiring a Debtor through its Chapter 11 Plan

- Chapter 11 of the Bankruptcy Code permits the acquisition of a company through a plan of reorganization.
- The plan of reorganization is approved at the end of the Chapter 11 bankruptcy process.
- The plan of reorganization must be approved by at least two-thirds in amount and by the majority in number of claims of each class of creditor claims.
- Numerous other substantive and procedural requirements are set out in the Bankruptcy Code; experienced counsel is necessary.
- Oftentimes a debtor will push for a plan process because it is a way to provide releases to directors and officers even though it can be more expensive and may not be as advantageous to a purchaser

Advantages of Confirmed Plan

- Can be a very flexible option in terms of structuring the entirety of the acquired business
- Broad releases of liabilities and obligations
- Public auction may not be required
- Exemption from transfer taxes
- Exemption from registration for securities issued under a plan
- Exemption from HSR Act
- Tax attributes (e.g., NOLs) may be preserved in certain circumstances
- Other potential tax reasons

Disadvantages of Confirmed Plan

- Process can be lengthy and expensive (typically 90-120 days)
- Risk of failing to line up all necessary constituencies to achieve plan confirmation
- Debtor estate must be financed throughout the process
- Lengthy bankruptcy may destroy much of the value of the debtor and its relationships with customers, suppliers, etc.
- Creditors get to vote on the Plan (unlike a 363 sale)
- COVID Consideration: potential for 363 sale combined with a liquidating plan

Article 9 Sale

- A sale by a secured creditor pursuant to Article 9 of the UCC – state law (with some variations) in all 50 states.
- Article 9 allows a secured creditor, after a default by a debtor, to "sell, lease, license, or otherwise dispose of any or all collateral in its present condition or following any commercially reasonable preparation or processing."
  – This process is often a consensual one between the lender and the borrower and is intended to maximize the value of the assets. It may have the benefit of increasing distributions to other creditors if the lender is made whole and there are excess sale or other liquidation proceeds.
- Article 9 does not apply to owned real estate secured by a mortgage (covered by separate state foreclosure laws)
- Theoretically faster, easier and cheaper than a 363 sale, since no bankruptcy filing, no unsecured creditors committee, more limited professional fees, etc.
- Risks of lack of cooperation, application of contractual remedies, no automatic stay, possible suit by junior lienors, multiple processes in different jurisdictions
- There is no ability to pursue preference claims and thus that value for general unsecured creditors may be lost.
- Single proceeding and potential availability of court "free-and-clear" order in a bankruptcy process generally cause acquirors to prefer 363 transactions to Article 9 sales (however a consensual foreclosure process does not involve a court process).

Assignment for the Benefit of Creditors (ABC)

- Liquidation of assets under state law by assigning all of the seller's assets to an "assignee" or trustee under a trust agreement.
- Some states require court oversight and others do not.
- Process begins very quickly
  - Simple Board resolution needed
  - Assignment document is relatively simple and straightforward
  - Equivalent of "tossing the keys" to the Assignee
- The assignee serves as a fiduciary for purposes of liquidating the assets and distributing the proceeds to creditors.
- Since the debtor is out of the picture, due diligence can be difficult, and trustee will not generally stand behind the assets.
- Leases/licenses/contracts are <u>not</u> assignable without consent where anti-assignment clauses exist.
- Assets cannot be assigned free and clear of liens, thus secured lender consent is required.

UNIQUE TERMS OF 363 TRANSACTION AGREEMENTS

Preliminary Agreements

- Confidentiality Agreements:
  - Note: in bankruptcy, US Trustee, Creditors Committee, DIP Lender and Judge will usually gain full access; also conflicts with very limited confidentiality rules in bankruptcy, thus US Trustee likely to object.
- Exclusivity Agreements
  - Note: in bankruptcy, generally <u>unenforceable</u> since Debtor/Seller is a fiduciary with a federal duty to market the assets aggressively.
  - Limited exclusivity in certain circumstances.

Purchase Agreements

- The purchase agreement in a Chapter 11 sale has several differences from a non-bankruptcy purchase agreement:
  – There will usually be detailed provisions regarding the bankruptcy process, including deadlines for the presentation of motions to approve bid and auction procedures and the sale itself.
  – The consideration may include a “credit bid” of the value of claims held by the purchaser against the seller.
  – There will likely be fewer representations and warranties and limited post-closing indemnification (if any); the purchaser should not expect to have significant remedies against an insolvent seller.
  – There will likely be fewer post-closing covenants (e.g., transition services, tax matters, non-competes) from the seller because the seller will likely not have the means to perform post-closing.

Purchase Agreements

- There will be a process for the designation, assumption and assignment of contracts, including mechanisms for the determination and payment of cure costs.
- There may be fewer closing conditions because the Bankruptcy Code nullifies typical conditions like stockholder approval and consents otherwise required by third-party contracts; however, closing will be conditioned on the entry of a sale order approving the sale.
- Provisions concerning expense reimbursement or break-up fees may be included and will address priority of claim issues (e.g., whether such amounts will be senior to the senior secured lender).
- The parties will submit to the bankruptcy court's jurisdiction to resolve disputes, and federal bankruptcy laws will govern, in addition to state laws where appropriate.
- Disclosure schedules are not typically finalized until the auction concludes.

Key Takeaways From This Session

- COVID-19 may shift focus of directors to job preservation
- Exhaustion of PPP funds may be a consideration
- In current environment, parties will be looking to complete sales quickly and at low cost as funds may not be available to fund a longer, more expensive process
- Out-of-Court Transactions may be preferred – but risks remain
- Speed will be at a premium for 363 Sale Process
  - May impact where cases are filed
- Debtors will be focused on wrapping up cases quickly through plan process that provides releases

Questions?

Biography

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Andrew Gallo is both an accomplished trial lawyer and bankruptcy attorney. Andrew counsels secured and unsecured creditors, equity holders, and investors in complex Chapter 11 cases and out of court restructurings. He also litigates creditors' rights cases in state and federal (including bankruptcy) courts, with specific experience in fraudulent transfer and lender liability cases. Andrew has also had multiple engagements representing creditors and other parties-in-interest in distressed situations relating to the oil & gas industry. He serves as deputy leader of the firm's bankruptcy and restructuring practice and as co-leader of the firm's energy industry team.

Previously, Andrew was a law clerk for Judge Sidney H. Stein, United States District Court for the Southern District of New York. Before joining Morgan Lewis, Andrew was a partner in the financial restructuring practice at another international law firm, where he helped run the training programs for litigation associates.

Biography

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Craig A. Wolfe has more than 20 years of experience counseling clients facing financial distress. Craig also represents sellers and purchasers of specific assets and entire businesses in the context of Chapter 11 bankruptcy cases. His clients span a wide range of industries and sectors, including retail, apparel, food and beverage, packaging, technology, ocean shipping, shipbuilding, petroleum trading, offshore oil, pipeline, transportation and logistics, entertainment, telecommunications, chemical, aircraft, steel, publishing, manufacturing, and printing.

Craig has helped numerous companies avoid becoming Chapter 11 debtors, often on the eve of a potential filing and fully prepped for the "first day" hearing if bankruptcy became necessary. He also represents strategic financial and private equity clients in purchasing distressed businesses and specific assets, as well as creditors' committees in the bankruptcies of companies across multiple industries.

Biography

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Kevin S. Shmelzer combines his skills as a lawyer and his prior experience as a certified public accountant to address corporate and securities matters. Kevin works on global mergers and acquisitions (M&A), public and private debt and equity offerings (including IPOs), private equity transactional matters, investments, divestitures, joint ventures, corporate governance, and general representations of public and private companies. He represents public and private clients in a number of fields, including the energy, technology, banking, life sciences, retail, utilities, healthcare, manufacturing, fintech, digital health, and sports industries.

In addition to serving as outside counsel for his clients, Kevin served as the acting general counsel of Taminco Global Chemical Corporation (acquired by Apollo Global Management on February 15, 2012 and, at such time, the company had $1.1 billion in revenues and 750 employees in 18 countries) from March 2012 to August 2012. Kevin managed all legal aspects of the company's operations, including primary responsibility for corporate governance and board secretarial duties, strategic alliances, joint ventures, acquisitions, commercial matters, litigation and claims, financings, subsidiary management, intellectual property, purchasing, employment, sales, and marketing compliance matters.

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Laura McCarthy's practice focuses on commercial and bankruptcy litigation, complex reorganizations, out-of-court workout matters, as well as corporate insolvency and restructuring. She works with major US and international financial institutions, creditors, and investors in the resolution of distressed financial situations. Prior to joining Morgan Lewis, Laura practiced law at a regional firm where she gained experience in bankruptcy law, including debtor and creditor advocacy, as well as corporate matters.

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