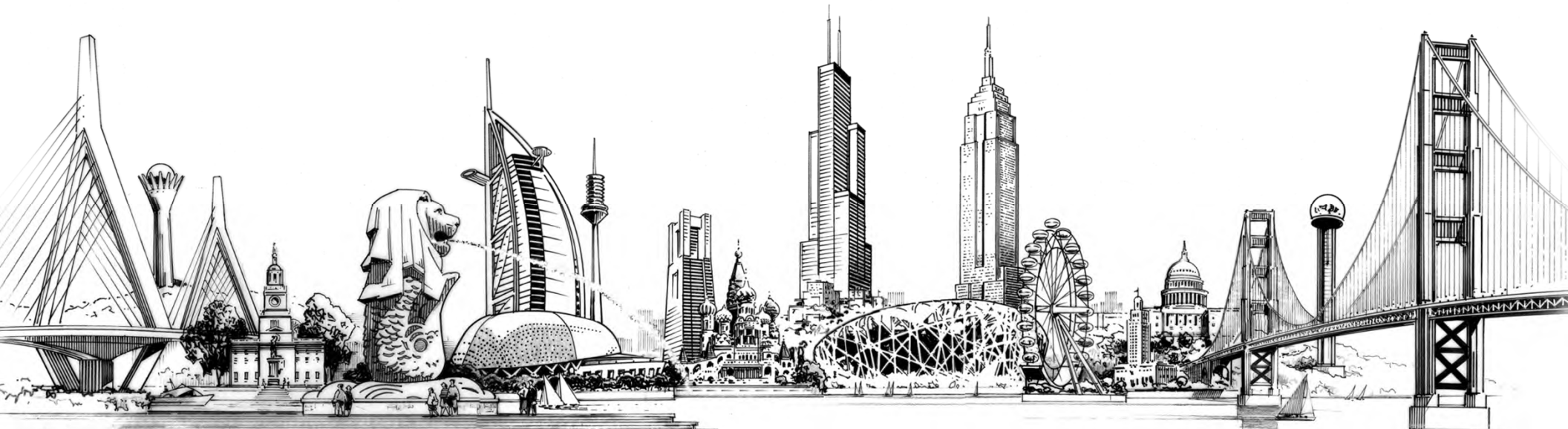


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**ISSUES IN  
DISTRESSED M&A  
TRANSACTIONS**

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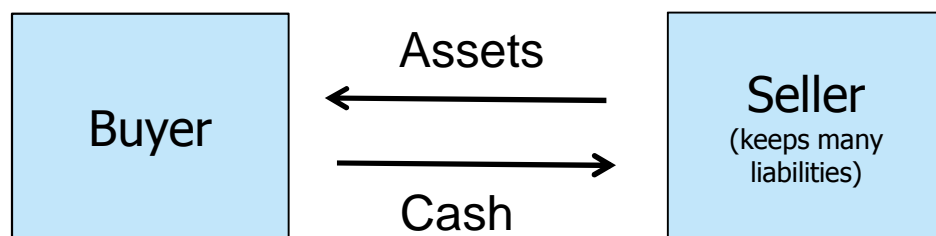
# Overview

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- Common Transaction Structures
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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 all of the seller's liabilities.



- As a general rule, a purchaser of assets is not liable for the liabilities of the target. This is unlike acquisitions of stock 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)
- These exceptions need to be considered when structuring and documenting an acquisition

# Fraudulent Conveyance

- Fraudulent Conveyance under the Bankruptcy Code
  - Actual Fraud
    - A debtor can avoid transfers it made prior to a bankruptcy filing if it made the transfer within two years before the filing “with the actual intent to hinder, delay or defraud” any entities that were or that became creditors of the debtor.
  - “Constructive” Fraudulent Conveyance
    - A transfer may be avoided if the debtor received less than “reasonably equivalent value” in exchange for the transfer, and the debtor:
      - was insolvent at the time of the transfer or as a result of the transfer;
      - engaged in business with “unreasonably small capital”;
      - intended or believed that it would incur debt beyond its ability to pay; **or**
      - made the transfer for the benefit of an insider and not in the ordinary course of business.
- State Fraudulent Conveyance Laws
  - Similar to federal law, but state laws often have look-back periods longer than two years.

# Fiduciary Duties of Target Company Directors

- Familiar fiduciary duties apply:
  - Duty of loyalty
  - Duty of care
- Business judgment rule
  - State law doctrine (based on state of incorporation) that, in general terms, protects directors from second-guessing if board action meets threshold:
    - Disinterested director
    - Acting in good faith
    - In a manner reasonably believed to be in the best interests of the company
  - Under normal circumstances, neither courts nor stockholders should interfere with the managerial decisions of the directors (*Omnicare, Inc. v. NCS Healthcare, Inc.*)
  - The business judgment rule does not apply in all circumstances

# Fiduciary Duties of Target Company Directors

- In a financially healthy corporation, directors owe fiduciary duties to shareholders
- When a corporation is in or approaching the “Zone of Insolvency,” however, duties expand to include creditors
- Tests for insolvency:
  - Liabilities exceed assets; or
  - Inability to pay debts as they come due
- If the corporation ultimately is insolvent and is liquidated, then the shareholders ultimately will have no economic interest
- Courts thus recognize creditors as being an additional constituency to whom duties are owed, as residual beneficiaries of the value of the corporation when it nears or enters the zone of insolvency



# **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

# Advantages of Out-of-Court Transactions

- Usually the fastest option
- Avoid potential negative effects of a bankruptcy on a seller's relationships with customers, suppliers, and employees

# Disadvantages of Out-of-Court Transactions

- Do 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
- Must deal with anti-assignment clauses in assumed 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

# Other Potential Considerations

- The seller may not be able to provide post-closing transition services.
- 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.
- The seller may have deteriorating relationships with key customers, suppliers, and employees.

**363 SALES**

# What Is a “363 Sale”?

- 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, pursuant to a bankruptcy court order
- A “363 Sale” gets its name from Section 363 of the Bankruptcy Code, which governs the sale of property of a debtor.
  - Section 363 provides that ordinary course transactions do not require approval of the bankruptcy court.
  - The sale of a significant portion of assets, such as an M&A transaction, would be outside of the ordinary course and require notice to interested parties and bankruptcy court approval.

# 363 Sale Requirements

- Standard for approving 363 Sales:
  - There must be a “good business reason” for the proposed sale (*In re Lionel Corp.*), which includes consideration of the following factors:
    1. The proportionate value of the assets to the estate as a whole;
    2. The amount of time elapsed since the filing;
    3. The likelihood that a plan of reorganization will be proposed and confirmed in the near future;
    4. The effect of the proposed distribution on future plans of reorganization;
    5. The proceeds to be obtained from the disposition compared to any appraisals on the assets; and
    6. Whether the asset is increasing or decreasing in value.
  - Interested parties must be provided with adequate and reasonable notice
  - 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 an auction process in order to satisfy the “fair and reasonable” price requirement.



# 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 and expense reimbursement
    - Any break-up fee is typically covered by the required “overbid,” or amount by which the initial counteroffer must exceed the stalking horse bid
  - A hearing occurs at which the bid procedures, auction procedures, and any stalking-horse purchase agreement are approved.

# 363 Sale Process

- Second Phase:
  - The stalking horse bidder is announced publicly and the debtor is publicly marketed to potential topping bidders.
  - Bidders are often asked to submit a markup of their proposed form of purchase agreement against the stalking horse's purchase agreement.
  - The stalking horse bidder may seek financing or regulatory approval during second phase.
  - An auction is held and highest or best bidder is chosen.
  - A second hearing occurs to seek approval of the sale, at which the seller presents to the bankruptcy court the highest or best offer received.
- The transaction usually closes shortly after approval by the bankruptcy court, subject to waiver of 14-day stay period by the bankruptcy court.

# Advantages of 363 Sales

- Protections provided under sale order, including:
  - The purchaser acquires assets free and clear of liens, which can significantly limit successor liability claims.
  - A determination by the bankruptcy court that the consideration paid was fair and reasonable, which provides significant protection against a fraudulent conveyance claim.
- 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

# Disadvantages of 363 Sales

- A public auction is generally necessary
- 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

# 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.
  - Claimants are arrayed in a waterfall, with the secured lenders on top and equityholders at the bottom
  - Potential acquirors may buy secured or unsecured claims to participate in the bankruptcy process
  - Want to be at the point in the waterfall – the “fulcrum security” – where the money runs out, and equity interests are distributed
- 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.

# 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

# Disadvantages of Confirmed Plan

- Process can be lengthy and expensive
- 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.



# 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.”
- 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
- Single proceeding and availability of court “free-and-clear” order generally cause acquirors to prefer 363 transactions to Article 9 sales

# 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.
- Process begins very quickly
  - Assignment document is relatively simple and straightforward
  - Equivalent of "tossing the keys" to the trustee
- 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

# **UNIQUE TERMS OF 363 TRANSACTION AGREEMENTS**

# Preliminary Agreements

- Confidentiality Agreements
- Standstill Agreements
- Exclusivity Agreements

# 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 the value of claims against the seller.
  - There will likely be fewer representations and warranties and limited post-closing indemnification; 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.

# Biographies



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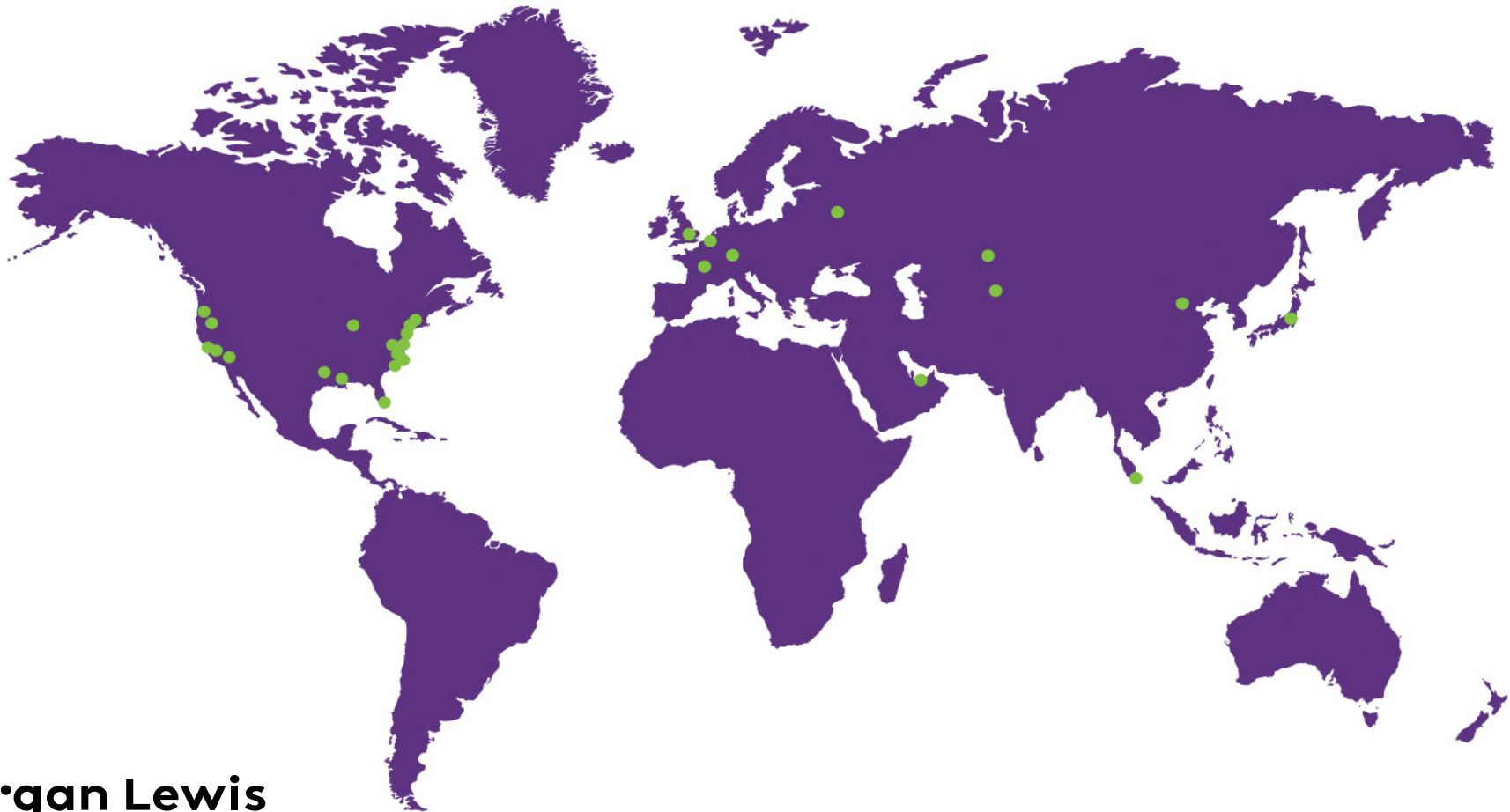
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