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Distressed Acquisitions — Key Considerations

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The current COVID-19 pandemic is causing an unprecedented negative impact on businesses around the globe in nearly every sector of the economy. Both the US Government as well as Foreign Governments have and will continue to provide short- and long-term financial support to these businesses. However, this financial assistance will not be available to every business, nor will it be adequate in all instances to offset decreased revenue resulting directly and indirectly from the pandemic. As a result, many businesses will be unable to accurately forecast and will not have the necessary liquidity to ride out the pandemic, and will seek solutions to preserve value for their stakeholders, including through the pursuit of a sale. Both strategic purchasers and institutional investors will have opportunities to purchase these businesses (or certain related assets) either through a regular sale process or under the supervision of a bankruptcy court. Due to the nature of these sales, a number of additional issues arise that potential purchasers should bear in mind.

Key Considerations Related to Distressed Sales Out-of-Court

At a high level, sales of distressed targets that take place outside of bankruptcy court appear fairly similar to non-distressed M&A processes. The transaction documents tend to include many of the same deal concepts, and the acquisitions are generally subject to the same array of third-party consents that tend to be at issue in connection with the purchase of a stable company. Just below the surface, however, lie significant issues that potential purchasers must consider when pursuing the acquisition of a distressed company out-of-court, including:

- **Structure.** An out-of-court sale of a distressed company may be structured as an asset sale, equity sale or merger, but a potential purchaser will often prefer to structure it as an asset sale in order to leave behind the target's assets and liabilities that resulted in it becoming distressed. While an asset sale structure is generally effective in limiting the purchaser's potential exposure to excluded assets and excluded liabilities, the purchaser should still be mindful of any significant excluded liabilities of the target for which it may be liable under a successor liability theory. The structure may be dictated by or result in significant tax implications triggered by a sale.

- **Diligence.** A potential purchaser of a distressed company should take extra care to conduct a thorough due diligence investigation in order to identify liabilities that it may wish to exclude and to better understand how the target's business and underlying assets have been affected as a result of its likely cost-cutting efforts. Maintenance of the target's key assets and payment of its accounts payable may have been deferred, and turnover in personnel may have caused other operational issues to arise. State and local records should be searched for financing statements, tax and judgment liens and lawsuit filings in order to determine whether any of the assets that the purchaser desires to purchase are encumbered or are the subject of litigation. In addition, a company's underlying physical assets, particularly real estate holdings, should be carefully reviewed and analyzed to assess value, liabilities, and utility with respect to ongoing operations.

- **Third Party Consents.** The consent of third parties, such as the target's stockholders and counterparties to assumed commercial agreements will likely need to be obtained as a condition to the sale of a distressed company's assets. In addition, parties will need to develop a strategy for obtaining the consent of the target's lenders to the extent that their loans are not repaid in full in connection with the closing of the acquisition. A purchaser of a distressed company should be prepared to navigate the competing interests of these different constituencies and the resulting tensions that are likely to arise.

- **Purchase Price Adjustments and Indemnities and Indemnification.** While an out-of-court purchase agreement for a distressed company will usually include post-closing purchase price adjustment and indemnification mechanics, the potential purchaser should be especially concerned about its ability to actually recover from the distressed company in respect of such obligations because of the company's tenuous financial condition. To mitigate the risk of non-payment, the purchaser should consider requiring a guarantee from a creditworthy affiliate of the target, a hold-back or escrow of a substantial portion of the purchase price, or insurance for any such adjustments. Alternatively, the assets may be priced on an "as-is, where-is" basis under the assumption that post-closing adjustments and indemnities may be unavailable.

- **Fraudulent Transfer Mitigation.** A purchaser of a distressed target should take steps to minimize the risk of the sale later being deemed a fraudulent transfer and set aside. A sale can be set aside if it is determined that the sale was actually intended to hinder, delay or defraud creditors or if it was made for less than fair consideration or reasonably equivalent value and the target was insolvent, rendered insolvent, or left with insufficient capital at the time of the sale. To limit this risk, the purchaser should bolster the record that "fair consideration" or "reasonably equivalent value" was paid, and should consider the need for a fairness and solvency opinion from a qualified investment bank, and the thoroughness of the sale process in terms of its openness to as many bidders as possible.

- **Timing of Closing.** A potential purchaser of a distressed company should seek to sign and close the acquisition simultaneously, or with shortest interim period possible if a later closing is necessary. If the target enters bankruptcy prior to the closing of the out-of-court sale, it will have the ability to reject the purchase agreement and the purchaser would be left with an unsecured, pre-petition claim against the target for its damages.

Key Considerations Related to Distressed Sales in Bankruptcy Court

In comparison to the out-of-court sale process of a stable or distressed company, a sale of a debtor that takes place under the supervision of a bankruptcy court looks very different. A debtor in a bankruptcy case can sell its assets by way of a formal plan of reorganization in which the debtor's debt and capital structures are restructured and a new "reorganized" entity is formed to take title to the assets, with all or most of the equity in the new entity issued to the purchaser, or through a liquidating plan. The reorganization plan process in bankruptcy is extremely complex, time consuming and expensive, however, which often leads debtors to undertake asset sales under Section 363 of the Bankruptcy Code, typically via a public auction. In that scenario, the debtor typically selects an initial bidder as the "stalking horse" whose bid sets a purchase price floor which is subject to better bids that may be received from competing bidders in a public auction. While some of the concerns raised by out-of-court distressed sales, such as the heightened need for thorough due diligence, are also present in 363 sales, 363 sales alleviate some of the downsides of out-of-court distressed sales; for example, (i) the purchaser acquires the assets free and clear of liens, which can significantly limit successor liability claims, (ii) in approving the sale, the bankruptcy court determines that the consideration paid was fair and reasonable, which protects against fraudulent conveyance claims, (iii) most contracts can be assigned without the consent of the counterparties, (iv) approval of the sale by the target's stockholders is not required, and (iv) non-consenting lenders can be sidestepped. Nevertheless, the unique attributes of the 363 sale process raise substantial issues that potential purchasers should consider, including:

- **Stalking Horse.** A potential purchaser of a debtor in a 363 sale should consider whether it would like to be the stalking horse bidder or wait for the sale terms approved by the bankruptcy court and then decide whether to make a topping bid. While the stalking horse generally has a better opportunity to conduct thorough due diligence and negotiate certain deal protections, it does face the risk of agreeing to an unnecessarily high purchase price. A stalking horse bidder can usually obtain court approval of reasonable termination fees and minimum bid increments that will apply to competing bidders.

- **Deal Protections.** Some of the primary deal protections and bid procedures that the stalking horse can seek include the setting of a bid deadline and an auction date and the inclusion of provisions regarding qualified bidder criteria, overbid requirements, matching rights, termination fees and expense reimbursement. The parties will want to ensure that such provisions are reasonable, however, as the bankruptcy court can deny approval of the stalking horse's purchase agreement if it includes an excessive termination fee or provides for reimbursement of expenses which are not based on the actual, reasonable expenses incurred by the stalking horse. The stalking horse should also press for court approval of the bid procedures and a court finding that the sale was in good faith, in order to make the results of the auction final and not subject any change even after an appeal – otherwise the debtor or the bankruptcy court may move to reopen the auction.

- **Representations and Warranties; Indemnification.** The sale of a debtor's assets in a 363 sale is usually made on an "as is, where is" basis, with very limited representations and warranties that do not survive the closing of the sale. Indemnification of the purchaser by a debtor in the 363 sale context is unusual. For these reasons, a potential purchaser should expect to have very limited, if any, post-closing recourse against the debtor.

- **Executory Contracts.** A debtor in a 363 sale can reject burdensome "executory contracts," while assuming or assigning valuable contracts. An "executory contract" is a contract in which the debtor and the counterparty each have unperformed material obligations. If there are monetary defaults under an executory contract, the defaults would need to be cured as part of the assignment of such agreement to the purchaser in the 363 sale. Such cure can either be effectuated in connection with the closing of the 363 sale or through a negotiation between the purchaser (or debtor) and contract counterparty. The cure costs will usually ratably reduce the purchase price paid by the purchaser, so in determining the "value" of a bid at the auction, these costs and the costs of the claims left behind need to be factored into any bid to determine the true value offered.

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