Distressed M&A: Assessing Opportunities for Bargain Purchases

JEFF ANAPOLSKY
Jeff is a graduate of Harvard Business School and Harvard Law School with experience in multiple industries.

Bankruptcy often presents an opportunity for qualified bidders with access to cash to purchase quality assets at bargain prices. However, it also brings a major challenge: How do you assess the value of businesses with risky strategies, dwindling liquidity, limited resources, and uncertain prospects? Before considering a distressed purchase, a prudent investor must diagnose the primary cause of distress, evaluate a target company's overall financial health, recognize whether its operations can be saved, and if so, acknowledge the amount of time, effort, and capital required to turn a business around.

Pre-bankruptcy: Beware Fraudulent Transfer Risk

Before purchasing assets from a distressed business, it is important to be aware of fraudulent transfer risk. A fraudulent transfer occurs if the seller was insolvent at the time of the transaction (or became insolvent as a result of the transaction) and the transaction involved "less than reasonably equivalent value." Any transfer of assets that occurred within two years prior to the seller's bankruptcy is at risk of being reclassified as a fraudulent transfer under federal law, meaning the transaction could be voidable. Additionally, fraudulent transfer law in nearly all states allows a four-year lookback period. During bankruptcy, if the seller's creditors suspect a fraudulent transfer has occurred, they may initiate litigation against the buyer to unwind the deal or hold the buyer liable for economic damages. Since any pre-bankruptcy M&A transaction carries fraudulent transfer risk, buyers should proceed with caution when approaching a distressed seller prior to an impending bankruptcy filing.

Fraudulent Transfers Defined

"Less than reasonably equivalent value" is an intentionally ambiguous term that is not defined in the Bankruptcy Code, enabling courts to interpret it on a case-by-case basis. In general, courts will view reasonably equivalent value as not necessarily equal to fair market value but generally more than a fire sale price or forced liquidation value. While reasonably equivalent value may be approximated by net orderly liquidation value, such estimates may involve considerable speculation. Since defining these terms requires a subjective judgment by the courts, buyers should analyze and thoroughly document buyer-seller communications and recent comparable transactions to defend against any subsequent fraudulent transfer accusations by disappointed creditors in a subsequent bankruptcy proceeding.

Overall, buyers should be particularly wary of any sweetheart deals when dealing with a distressed seller. If a deal sounds too good to be true, it probably is! While buying assets from a distressed seller at a pre-bankruptcy auction may reduce fraudulent transfer risk, acquiring the seller's assets through a post-bankruptcy 363 sale is the best practice. Even if the buyer expects to ultimately prevail in fraudulent transfer litigation, the costs, distraction, and hassle of litigation should create a significant deterrent.

Distressed M&A Works Best Through 363 Sales

For companies fortunate enough to have ample cash on hand, a macroeconomic or industry-specific crisis could provide an ideal environment to purchase assets from bankrupt competitors at bargain prices. The main mechanism for such a transaction in bankruptcy is known as a 363 sale because the sale of assets in bankruptcy is governed by Section 363 of the Bankruptcy Code (11 U.S.C. § 101, et seq.). Distinct from traditional M&A, distressed M&A via a 363 sale usually involves an all-cash transaction where assets are sold on an "as is, where is" basis with limited representations, warranties, and escrows.

363 Sales: Assets Purchased "Free and Clear"

In addition to avoiding fraudulent transfer risk, the primary benefit of a 363 sale is buying assets "free and clear" of all liabilities, claims, and debts (see 11 U.S.C § 363). The goal for a 363 sale is to obtain the highest and best value for the assets being sold without regard for the validity and amount of pre-bankruptcy liabilities, claims, and debts against those assets. Otherwise, bidders would likely discount their bids subjectively based upon imperfect information and understanding of creditors' claims.

"Free and clear" does not address certain industry-specific contracts, leases, joint ventures, and other agreements because these are not considered liabilities, claims, or debt by the Bankruptcy Code. Instead, these types of agreements are governed by a different part of the Bankruptcy Code that permits the seller to (i) assume and assign them or (ii) reject them as part of a 363 sale (see 11 U.S.C § 365). The winning bidder can specify in the purchase agreement which agreements to keep and which to abandon. The seller then assumes and assigns the former and rejects the latter prior to closing.

If assumed and assigned, the seller and buyer *must* cure all defects prior to closing, such as paying any unpaid rent on an office lease. The buyer *may* need to satisfy other requirements of the agreement, which could entail submitting a deposit or any other credit enhancement. If rejected, then the counterparty to the agreement receives rejection damages as a general unsecured claim against the company. Like other creditors' claims, rejection damages are resolved as part of the company's bankruptcy process. The "free and clear" benefit of a 363 sale means that the 363 sale buyer has no liability for general unsecured claims, including rejection damages.

However, a company's ability to reject certain industry-specific contracts in bankruptcy may be less clear than rejecting vendor contracts and equipment leases. In the oil and gas industry, for example, gas gathering midstream contracts were rejected in a landmark 2016 New York bankruptcy court case (see Sabine Oil and Gas) but upheld in 2019 in cases before a Colorado bankruptcy court (see Badlands Energy) and a Texas bankruptcy court (see Alta Mesa Resources).

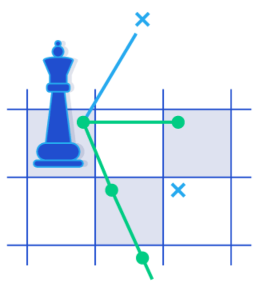
Additionally, for licenses and patents, a bankrupt licensor cannot reject an intellectual property agreement if the licensee continues to pay royalties required by the agreement before and after the bankruptcy case begins. To resolve ambiguity over whether intellectual property agreements relating to trademarks could be rejected in bankruptcy, the US Supreme Court held that licensors cannot use bankruptcy to reject or revoke trademark licenses where the licensee continues to perform under the agreement (see Mission Product Holdings Inc. v Tempnology LLC).

As demonstrated above, contract law, bankruptcy law, and court precedents continue to evolve, creating complexity when determining which contracts can be rejected in bankruptcy as part of a 363 sale. As such, before bidding in a 363 sale, potential bidders should consult with qualified attorneys to understand how the terms of an underlying contract and the interpretation of applicable state laws can affect their ability to reject certain contracts.

Creditors' Negotiating Leverage to Influence 363 Sales

Legally, only the bankrupt company can propose a 363 sale. This situation may present a conflict of interest if entrenched management prefers a standalone plan of reorganization where the business continues as an independent entity. Creditors possess many options in their toolkit to influence the debtor to commence a 363 sale. Secured creditors can attempt to restrict liquidity for operating in a Chapter 11 proceeding or lift the automatic stay to seize their collateral. In addition, any creditor may vote against any standalone plan of reorganization, request that the court terminate the debtor's exclusive right to propose a plan, or seek to appoint a **Chief Restructuring Officer (CRO)** or **Chapter 11 Trustee**. Creditors would hope that such an appointment would remove any conflicts of interest to clear the path to a 363 sale, but they may face new hurdles in achieving their objective.

How Creditors Can Influence 363 Sales



1	Restrict liquidity for operating in a Chapter 11
2	Vote against any standalone reorganization plan
3	Terminate the debtor’s exclusive right to propose a plan
4	Appoint a CRO or Ch. 11 trustee free of conflicts of interest
5	Lift automatic stay to seize assets

363 Auctions: “Stalking Horse” Bidder

Qualified bidders in a 363 sale must submit a binding offer with no contingencies for due diligence or financing. While most 363 sales involve an auction so that valuation is determined by the market, an auction is not required by the Bankruptcy Code. To get the bidding started in a 363 auction, the company may choose an initial bidder known as the “stalking horse.” Once chosen, the company and the stalking horse enter into a binding purchase agreement that sets the minimum valuation for the assets. This purchase agreement is made public so competing bidders have an opportunity to bid higher.

The stalking horse position is usually coveted since this bidder receives a first look at confidential information, benefits from more time to conduct due diligence, sets the breakup fee (typically capped around 3% of the bid), and influences the qualification requirements for competing bidders as well as the overall auction timetable. The stalking horse can also influence how the company’s assets are packaged: multiple sales vs. one comprehensive transaction. If another bidder subsequently outbids the stalking horse, then the stalking horse can either raise its bid or walk away with the breakup fee. Ultimately, these and other protections allow the stalking horse to entrench its position to purchase quality assets at the best bargain price.

Advantages of the “Stalking Horse” Bidder

1	Gains a first look at confidential information
2	Determines the breakup fee (usually 3% of bid)
3	Influences which assets are sold, terms and conditions, deadlines, and legal documentation
4	Sets minimum topping amount (overbid protection)
5	Requires qualifications for other bidders to limit competition

363 Sales: Qualified Bidders

Typically, there are three categories of qualified bidders in a 363 sale:

1. Financial bidders (hedge funds and private equity firms)
2. Strategic bidders (competitors and new entrants)
3. Credit bidders (secured creditors)

In order to become qualified to bid, interested buyers must demonstrate their financial ability to close a sale if they submit the winning bid. In some cases, bidders may be required to put a refundable deposit in escrow. Usually, deposits are refunded promptly after the auction for everyone but the runner-up bidder in case the winning bidder fails to close as planned.

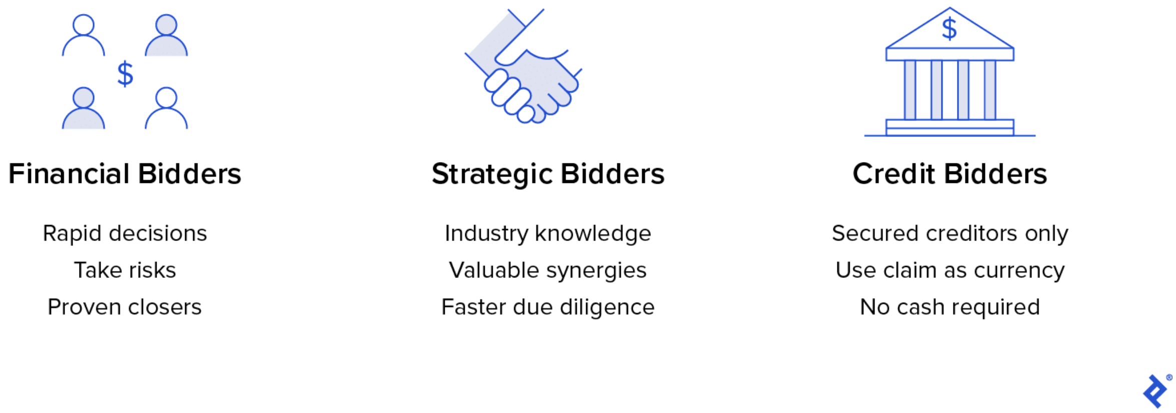
Financial bidders are known for their rapid decision-making, an especially important trait during bankruptcy as it is often a race against the clock to maintain liquidity. Their appetite for risk-taking and their proven ability to close a deal are other advantages. Usually, financial bidders know the Bankruptcy Code and 363 sale process, making them more attractive buyers for distressed M&A.

Strategic bidders bring their industry knowledge to the table, allowing for expedited due diligence because of their familiarity with the bankrupt company's customers, products, services, markets, vendors, competition, and regulation. In addition, strategic bidders usually possess valuable synergies with the bankrupt company because they can eliminate duplicative overhead costs, consolidate underutilized facilities, gain stronger market share, improve operational inefficiencies, and lower overall borrowing costs.

While synergies should enable strategic bidders to submit higher bids than financial bidders in theory, financial bidders are often able to move faster to become the winning bidder at a 363 sale. Many strategic bidders are unfamiliar with the 363 sale process and have internal hurdles for approving potential bids. Also, strategic bidders may view the bankrupt company as an undesirable, weak competitor that is not worth acquiring. Strategic bidders have the alternative of investing in recruiting and marketing to capitalize upon a competitor's bankruptcy. Therefore, some 363 sale processes seek to limit the involvement of strategic bidders to prevent competitors from obtaining confidential information to use against the company later.

Lastly, secured creditors with valid, perfected liens on particular assets are able to "credit bid" using the face value of their debt, regardless of the market value or expected recovery of that debt. Thus, without contributing additional cash, secured creditors are able to set a floor on valuation and prevent opportunistic bidders from getting a sweetheart deal. Therefore, it is important to identify the holders of the secured debt to understand their motivations before proceeding with the bidding process. If the secured debtholders are traditional commercial banks, they are unlikely to want to take the keys and operate the bankrupt company but will not want to allow the winning bid to fall below liquidation value. On the other hand, if they are hedge funds or alternative lenders, then they may seek to take over the bankrupt company or, if not, may have a lower cost basis in the secured debt that makes a below-par bid from a third party attractive because they can generate a quick gain on the investment.

Who Bids in a 363 Sale?



363 Sales: Credit Bidding

In most 363 sale processes, a secured creditor has the right to use the face value amount of its secured debt as currency at auction. A secured lender can use its right to “credit bid” to prevent a borrower from selling collateral at too low a price in a 363 sale, such as below liquidation value. This right has created a “loan to own” strategy in which an investor can purchase secured debt at a discount and then bid up to the face value of that secured debt during the 363 sale auction without contributing additional cash.

A potential bidder may purchase debt of a bankrupt company at a discount with the goal of converting the debt to equity and owning the underlying assets of the business once the bankruptcy process concludes. Investors who have utilized the “loan to own” strategy usually take the following steps: purchase prepetition secured debt at a discount, become the post-petition debtor-in-possession (DIP) lender, roll over prepetition secured debt into the post-petition DIP loan, require a 363 sale where the DIP lender becomes the stalking horse bidder, insist upon an expedited marketing process, chill the bidding by other interested parties and co-opt parties by requiring a higher breakup fee, and finally, credit bid at the 363 auction.

A successful credit bidder acquires assets at a bargain price because the debt discount reduces the cash required to finance the purchase price. On the other hand, an unsuccessful credit bidder still enjoys a favorable outcome because the winning bid ultimately generates a cash gain for the credit bidder up to the value of its debt discount plus a breakup fee for being the stalking horse bidder.

Conclusion: Astute Maneuvering Leads to Successful Deals

In distressed M&A, interested buyers must navigate unfamiliar concepts, terminology, and processes where experienced financial and legal advice can prove essential. While there are many iterations of ways to participate in distressed M&A, not all transaction strategies result in successful deals. Distressed M&A is best achieved in bankruptcy through a 363 sale to avoid fraudulent transfer risk. In a 363 sale, there are advantages to becoming a stalking horse bidder, assuming there will be an auction, which is common but not required.

Winning a 363 auction may require outmaneuvering financial bidders, strategic bidders, and credit bidders, who may enjoy unfair advantages of non-cash bidding using secured debt purchased at a discount. Although the winning bidder purchases assets of a bankrupt company free and clear of claims and debts, the purchase agreement should be negotiated carefully to address assumption and rejection of contracts and leases. Ultimately, the reward for successfully overcoming all of the issues and hurdles in distressed M&A is a potential bargain purchase.