Bankruptcy's Up Side

Acquiring the discounted assets or equity of bankrupt companies can be a lucrative investment strategy. BY SCHUYLER CARROLL, COLONEL BETZ AND RICHARD LONDON

THE CONTINUED UNCERTAINTY IN THE stock market coupled with the coming wave of loan maturities have left investors looking for alternatives asset classes and different places to park their money.

One area investors might want to take a look at is bankrupt and distressed companies.

Many well-known and sophisticated investors have made fortunes in distressed companies, and family offices have also turned their attention to the opportunities in this arena.

Investors interested in purchasing discounted assets and entities, investors willing to consider creative purchase options and structures, and those open to a transaction requiring court approval may find the bankruptcy process to be an attractive alternative to other types of securities.

In analyzing this opportunity, this article provides a brief overview of the bankruptcy process (focusing on Chapter 11 bankruptcy cases) and discusses the two principal ways of acquiring assets or equity through a bankruptcy case.

Brief Bankruptcy Primer

The bankruptcy process is governed by federal law and administered by federal bankruptcy courts throughout the United States and its territories. Bankruptcy judges are accustomed to overseeing large cases involving complicated issues of fact and law (think of General Motors, Lehman Brothers, Washington Mutual and WorldCom).

The "debtor" is the company that files for bankruptcy. Nearly any type of entity is permitted to commence a bankruptcy case with a voluntary petition. There is also a mechanism whereby a group of creditors (in most circumstances, three or more) can file an "involuntary petition" to force a debtor into bankruptcy. The filing of a bankruptcy petition creates a fictional "estate" that generally includes all of the debtor's present and future assets.

Upon filing, the debtor, through its officers and directors, often continues to manage its affairs as a "debtor in possession," or "DIP." In certain circumstances, usually involving fraud or gross mismanagement, a trustee will be appointed. The trustee takes over management of the debtor and displaces the officers, directors and shareholders.

Although it is called the "reorganization" chapter of the Bankruptcy Code, Chapter 11 offers a company the flexibility to accomplish various objectives, including a traditional restructuring, a debt-for-equity swap, a sale of equity or a sale of its assets as a going concern. Sometimes Chapter 11 is used for a straight liquidation or a "going out of business" sale.

Section 363 Sales

In recent years, the prearranged sale of assets has become the most prevalent type of bankruptcy filing.

Section 363 of the Bankruptcy Code allows companies to sell some or all of their assets outside the ordinary course of business, and it requires the approval of the bankruptcy court. If structured properly, so-called "Section 363 sales" are an efficient way to sell the debtor's assets. The debtor company has a great deal of flexibility in structuring these sales—so long as the process is transparent and its goal is to maximize value—even when creditor claims will be wiped out.

As is the case with a transaction outside of bankruptcy, a buyer looking at a distressed company can identify any liabilities that it might want to assume and those assets that it would acquire, including real property, personal property, contracts and leases, as well as those items it would like to exclude. Bankruptcy courts, meanwhile, regularly approve mechanisms to limit disruptions to the debtor company's business as a result of either the bankruptcy or the transaction. These mechanisms include transition service agreements and consulting agreements.

Section 363 sales have a number of advantages over transactions conducted outside bankruptcy. For example, if the buyer is also one of the company's creditors with a lien on the assets, Section 363(k) of the Bankruptcy Code allows the creditor to "credit bid" the entire amount of the debt. A third-party buyer (that is not a creditor) also can take advantage of this, reaching a deal to buy a lender's claim—often at a steep discount—and get a substantial leg up on the competition via the credit bid.

"Credit bid" is a term of art. It's the ability of lenders to essentially repay themselves without having to lay out the money. The following example should help illustrate one of the benefits of a strategy like this. Say a company called Deadbeat Inc. borrows $10 million from a lender (MegaBank), which gets a first priority lien on all of Deadbeat Inc.'s assets. Deadbeat Inc. can't repay the loan, and its assets are no longer worth $10 million. Deadbeat Inc. identifies a potential buyer (Bargain Hunter). Bargain Hunter is willing to pay $5 million to buy all of Deadbeat Inc.'s assets. MegaBank wants out, does not want to wait until the sale closes and is willing to accept $5 million and take a loss for the rest.

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Bargain Hunter approaches MegaBank and buys the bank's loan. Bargain Hunter then enters into a stalking horse agreement to buy all of Deadbeat Inc.'s assets for $5 million. Since MegaBank had a first priority lien on all of Deadbeat Inc.'s assets, MegaBank is entitled to all of the sale proceeds, but since Bargain Hunter bought MegaBank's loan, Bargain Hunter gets the money. Instead of actually paying that money to itself, Bargain Hunter can "credit bid" under the Bankruptcy Code and thus reduce the amount of the loan by the amount of the purchase price.

Let's take this example a step further. Another buyer (OverPayer) comes in and wants to bid against Bargain Hunter. OverPayer offers $7 million and says that since Bargain Hunter only paid $5 million, Bargain Hunter is only entitled to be paid (and thus, credit bid) $5 million. The Bankruptcy Code protects Bargain Hunter and allows it to credit bid the entire amount of the loan (i.e., $10 million)—even though it paid less. Thus, OverPayer will need to pay more than $10 million to win the auction.

This is where the real benefit of acting early and buying out the bank comes in. Bargain Hunter gets the benefit of the entire discount it got in buying the loan—and can use it to outbid other bidders.

Furthermore, the order approving the Section 363 sale should give the buyer the following significant safeguards and protections:

- Section 363(f) of the Bankruptcy Code says the debtor's assets can be transferred to the buyer free and clear of a wide variety of claims, liens, encumbrances and interests, and the sale order will include many determinations necessary to allow such a transfer. One makes sure that the buyer is not a successor and has no liability for the debts. There is also a waiver of bulk sales laws.
- Once the sale is approved, the likelihood of an appeal is very slim. The appeal of a sale order will be deemed moot as long as the buyer acted in good faith. Thus, the finding of good faith in a sale order will give the buyer significant comfort, after it has invested time and effort, that the sale will not be reversed.
- Since the sale goes on in a federal court-approved process, the risk of future litigation prompted by the transaction is greatly minimized. A transaction with a distressed company outside of bankruptcy, for instance, could be subject to fraudulent transfer claims by a creditor who asserts that the buyer did not provide fair consideration. Such litigation should be dismissed almost immediately in a bankruptcy case after the entry of a sale order (assuming that all parties acted appropriately).

Breakup fees, expense reimbursements and other bid protections designed to protect the buyer are also approved in nearly all cases. The bankruptcy court will often

require that the assets be marketed for sale and that the debtor conduct a sales process, which includes implementing bid procedures. The usual structure of a process with bidding procedures includes the debtor identifying a "stalking horse" purchaser of the assets with whom it has negotiated and executed a definitive agreement for the sale of substantial assets. The stalking horse agreement would be subject to a competitive bidding process, but the stalking horse would be entitled to a breakup fee (usually around 3% of consideration) and possibly an expense reimbursement in the event that its offer is outbid. The debtor would seek approval of the breakup fee, expense reimbursement and any other bid procedures. The bid procedures usually set forth the requirements of any competing bids, including the required structure of the offer (for example, if it were all cash and came without financing contingencies); the deadline for the submission of competing offers; the minimum amount of consideration that must be given in the competing offer (which, generally, is the consideration under the stalking horse agreement plus the breakup fee and the expense reimbursement plus a minimum overbid); the rules for any auction of the assets, including the amount of bidding increments; and the approval of backup bids in the event the winning bidder does not close the transaction.

After the bankruptcy court approves the breakup fee and bid procedures, the debtor will run the sales process and hold an auction. Then the court will conduct a hearing to consider approval of the sale and determine whether the sale is an exercise of the debtor's business judgment (a fairly low threshold to meet). Assuming that no other government approvals are necessary, the sale can close soon after the court's approval. Depending on the facts, a sales process often closes days after court approval and the entire process is often completed within 60 days from start to finish.

The sale is often approved on terms very favorable to the buyer. The potential discounted value, the structure of the transaction and the timing of the sale can make the option highly attractive next to other investment opportunities.

Sales Through Bankruptcy Plans

Another way to buy debtor assets is through a Chapter 11 reorganization plan. A reorganization plan, if it can be confirmed, is generally preferred to a Section 363 sale when a buyer seeks to acquire the equity interests in, rather than the assets of, a debtor or when the buyer seeks to issue new securities. The reorganization plan mechanism also may be favorable if there are other issues that need to be addressed in the transaction, such as a settlement of outstanding litigation or a merger.

The Chapter 11 plan is superior to a Section 363 sale in several respects:

- According to Section 1145 of the Bankruptcy Code, a security issued in connection with a Chapter 11 plan is exempt from registration with the Securities and Exchange Commission under many circumstances. This is important to a buyer because under a reorganization, the filing company's assets would vest when the company is reorganized, and that equity interest would then be issued to the buyer. This way, the buyer can purchase assets and at the same time issue free tradable stock—which can be listed on an exchange—or restricted or preferred stock, even when the debtor might not be permitted to.
- Section 1146 of the Bankruptcy Code says transactions included in the Chapter 11 reorganization plan will be free from stamp and transfer taxes. In this way, sales of real estate, for example, may proceed without payment of transfer taxes or other taxes required to record a deed.
- A Section 363 sale and the associated bidding process can still be contemplated under a Chapter 11 plan, and the bidding process can take place at the same time that the plan process plays out.
- A reorganization plan generally gives the parties more flexibility and allows them to find creative solutions to problems. For instance, Section 363 sales are not well designed for non-cash transactions, but those types of transactions can be made under a Chapter 11 plan.

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Like a Section 363 sale, a Chapter 11 reorganization plan will normally be a two-step process. First, the bankruptcy court will consider whether to approve a disclosure statement with background information about the debtor, the events that transpired in the bankruptcy case and the proposed transaction. If the court approves the disclosure statement, the debtor and any other proponents will solicit votes from creditors in favor of the plan. At the confirmation hearing, the bankruptcy court will evaluate whether the requisite creditors accepted the plan and whether the plan satisfies the requirements of the Bankruptcy Code. Assuming that government approvals are unnecessary, the

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plan can "go effective" or close soon after confirmation by the bankruptcy court. Depending on the facts, a plan process is often completed within 90 days after the execution of a stalking horse agreement.

Although Chapter 11 plans may be used to resolve tricky issues associated with bankruptcy transactions, they are not appropriate for all situations. If a buyer seeks a straightforward cash transaction to acquire assets that are not subject to stamp taxes or similar taxes, the buyer may be best served to pursue a Section 363 sale. (Stamp taxes per se are rare these days, but there are many similar taxes that fall under that definition, including most transfer taxes, sales taxes and gains or profits taxes.) Moreover, if the assets are quickly deteriorating in value or the debtor does not have the liquidity necessary to operate in bankruptcy pending a plan process, it may be best to proceed with a Section 363 sale. Furthermore, since the confirmation of the plan marks the debtor's exit from bankruptcy (which may be an orderly liquidation), proceeding via a plan may result in other parties raising objections that are not relevant to the sale, the buyer or the purchased assets (such as disputes between creditors over which creditor is entitled to the sale proceeds or whether the seller must pay certain taxes) that can result in a significant delay and interfere with the buyer's objectives.

Conclusion

Bankruptcy sales, whether through Section 363 sales or Chapter 11 reorganization plans, are meant to give a buyer a level of certainty about acquiring the assets or equity of a distressed entity. Either a sale order or a plan confirmation order can ensure the buyer is getting the assets free and clear and minimizes the risks associated with successor liability claims.

Although bankruptcy sales are often subject to bid procedures (and the possibility that the buyer will be outbid), the award of breakup fees and expense reimbursements and the approval of a structured bidding process can minimize the downside risk associated with competitive bidding (from the buyer's perspective).

These sales, when properly evaluated, present significant opportunities to the sophisticated investor to structure the terms of an asset or entity purchase and to close on the sale in a protective manner.

At a time when the securities markets are difficult to navigate and present various risks, bankruptcy sales offer a legitimate and attractive opportunity. Sophisticated investors and family offices should consider exploring these options.

Schuyler Carroll, Colonel Betz and Richard London are attorneys at the law firm Perkins Coie. Carroll is a partner in the firm's Bankruptcy & Workouts group and head of the firm's New York office. He focuses on complex restructuring, transactional, litigation and advisory work. He can be contacted at SCarroll@perkinscoie.com.

Based in Seattle, Betz is a partner and head of the firm's Family Office Services group and focuses on personal, tax and estate planning for individuals and families as well as the representation of fiduciaries in estate and trust administration. He can be contacted at CBetz@perkinscoie.com.

London is based in Dallas and of counsel in the firm's Business practice, specializing in all aspects of restructuring representations, including in- and out-of-court restructurings. He can be contacted at RLondon@perkinscoie.com.