

BUYER BEWARE

BY GEOFFREY T. RAICHT

With credit markets frozen and companies in need of relief from creditors, sales under Section 363 of the Bankruptcy Code have become a common means to quickly dispose of assets and ultimately make distributions to creditors. A Section 363 sale enables a debtor in bankruptcy to sell its assets free of all liens. In this current market environment, sales to insiders or fiduciaries of distressed companies have become more prevalent as a means to preserve long-term value.

Insider sales are not new. Parties who have injected large amounts of capital into a company that has become distressed do not wish to see their investments wasted. Instead, some investors may be willing to put more capital into a distressed company under certain circumstances. A 363 sale may provide an option for acquiring the debtor's assets through a newly capitalized entity. This new entity may be owned by the debtor's prior management or old equity and, depending upon the structure of the sale, by consenting holders of secured debt of the debtor. In some cases, even secured creditors may be willing to exchange their debt in the debtor for a smaller amount of debt in the purchaser on better terms.

Although little or nothing may be paid to unsecured creditors from sale proceeds, asset sales can be a means for insiders and other fiduciaries of the debtor to purchase its assets free and clear. While there is nothing per se inappropriate about a sale under this type of structure, due to the inherent possibility of misconduct, inside-buyers need to be mindful of the heightened scrutiny a bankruptcy court will bring to the proposed transaction.

Under these structures, insiders need to pay close attention to certain issues to improve the likelihood that the court will approve the sale. Given the likelihood that some creditors will suffer economic harm as a result of the sale, buyers should expect the scrutiny to be profoundly intense.

First, the beginning and end of any sale to an insider is all about disclosure. Courts can and do approve such sales, but only if they know what they are approving. One wise bankruptcy judge once advised a practitioner to always highlight for the court any controversial and nontransparent issues. The judge warned the attorney that he should not lead the court down a road where both the court and attorney would be embarrassed later. Truer words cannot be spoken regarding insider sales. The vast majority of dealmaking occurs in the conference

room and not the courtroom. Should a material relationship go undisclosed only to be discovered later, the chances of sale approval are greatly reduced. The burden of proof to demonstrate the propriety of the transaction rests with the proponent. Omissions in disclosures can greatly undermine the ability to carry this burden.

Second, thorough marketing and a transparent auction process go a long way to demonstrate the requirements of good faith and fair value. If an asset is properly marketed by a nationally recognized investment banker or financial adviser, put up for bid to third parties and properly noticed, it is easier for a court to find that the sale is for fair value. Fair value is usually defined by what a willing bidder would agree to pay for a given asset. If the assets are properly marketed and notice of the proposed sale is sufficient, it is difficult to argue that the insider has an unfair advantage and is paying a below-market price.

Conversely, if the asset is not extensively marketed nor sufficiently noticed, it will be difficult for a court to approve such a sale.

Finally, insiders need to be aware that in approving a 363 sale, a court may not release directors and officers from potential claims for prepetition breaches of fiduciary duty. This underscores the need for pre-bankruptcy best practices. For example, once a fiduciary, such as a director, decides to submit a bid for the assets of the company, he should promptly disclose this to the board and not take part in any further discussions with the board on the issue. If necessary, the board should create a subcommittee of independent directors to make decisions on the sale to avoid any potential conflict of interest.

A board should also maintain a robust record of its deliberations regarding the sale and note the absence of conflicted members. In the current climate, board members should anticipate a post-sale lawsuit from disgruntled creditors or shareholders who will argue that the board breached some fiduciary duty that resulted in damage. These claims may be inevitable, which further highlights the need for a properly documented record of the pre-bankruptcy sale deliberations.

Asset sales are a potentially useful tool for insiders to preserve value in companies and make distributions — either in the form of cash or stock in a new entity — to the company's creditors. Insider sales may go by the wayside when the credit markets eventually loosen up. Until that time, however, if undertaken with extreme care and forethought, insider sales may be a valuable structure to preserve the long-term value of companies in the current dysfunctional market.

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