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Different Routes Through the Minefield

Opportunities abound in a distressed market, though many still have to get their bearings

By Dennis J. White and Thomas O. Bean

The prospect of being able to acquire a troubled, but otherwise attractive business at a bargain price is prompting many strategic buyers and private equity firms to pursue distressed sale situations. In the ACG-Thomson Reuters Mid-Year Dealmakers Survey released in April, a majority of the private equity firm respondents indicated they would be pursuing distressed sales as part of their business strategy, some 20% for the first time.

On entering this arena, first time players soon learn that troubled business acquisitions present a far different set of ground rules, challenges and pitfalls than typical M&A transactions. First, distressed sales typically involve exigent circumstance (e.g., the company may be running out of cash or vendors may be withholding deliveries). It is akin to doing a deal in an emergency room. Second, distressed sales often involve fewer protections for buyers (e.g., truncated due diligence, minimal or no representations and warranties). Moreover, distressed sales often involve greater execution risk (e.g., claims or interference by unsecured creditors, lienholders, etc.), while the timetable is often unpredictable, as it may be affected by the actions of third parties. Perhaps most important, surprises abound.

Notwithstanding such challenges, the possibility of acquiring a company or its assets at a price far below that sought in sunnier times can be compelling. There is no single best route that is optimal for buyers in all cases. Some lead directly into a bankruptcy courtroom; in other cases, bankruptcy can be avoided. Whichever route is selected, however, the buyer should have a good understanding of where it wants to go and the advantages and disadvantages of each route for a given deal. Here are some basics.

Pre-bankruptcy

A buyer can always follow the well-trodden stock purchase route. It avoids a visit to the courthouse and any bankruptcy-related stigma. In doing so, however, liabilities and liens remain in place and consents are likely to be required from lenders and others.

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A second route is to just acquire assets and assume selected or no liabilities. The stockholders, who may receive little or no proceeds, must approve the transaction, and the company's lenders, who may fail to receive full repayment of their loan, must release their liens on the assets, and otherwise consent. Such an approach may also trigger re-negotiation of contracts and the need for new licenses and permits. Creditors might also challenge the sale as a fraudulent transfer, that is, a sale for less than fair value at a time when the seller was insolvent.

Another approach, sometimes referred to as "loan to own," involves buying the position of the senior secured lenders, sometimes well below par. There is no need to secure the consent of the stockholders or

company management. Once the transaction closes, the buyer can foreclose on the assets (wiping out unsecured and junior debt) and bid in the full outstanding principal amount of the original lenders' loan at the foreclosure auction. Orchestrating such a move is not a simple exercise. Negotiating with a bank group can be arduous. Also, management or creditors can throw the company into bankruptcy at any time.

Of course, the buyer can acquire assets at a secured lender foreclosure sale. Such a route is dependent on the lenders conducting such a sale. Even if the lenders do so, a number of events can derail a prospective purchase, including an intervening bankruptcy filing, competing bids, and abandonment of the company by management, vendors and customers.

Post-bankruptcy

Effectuating a sale through the bankruptcy process carries distinct advantages. Bankruptcy imposes a "time out" through the imposition of an automatic stay that bars creditors from pursuing enforcement and collection actions. Once issued, the bankruptcy court's order binds non-consenting creditors, lenders and other contractors. Finally, the buyer has the peace of mind of acquiring the assets free and clear of all liens, with a reduced risk of post-closing challenges or lawsuits.

All these advantages come at a price. Bankruptcy is expensive, time consuming, and played out in a public courtroom. There is a greater likelihood of competing bidders. There are more interested parties to consider and procedural hurdles to surmount. Then there is the bankruptcy judge who wields an enormous degree of power and discretion. Even within the bankruptcy process itself, there are multiple routes that beckon.

The first possible route is to become the "DIP lender," the new secured lender that advances cash to the debtor in possession to cover operating needs, sometimes in return for a super-priority lien, but with a successful conclusion far from guaranteed.

A second approach, one that has become increasingly utilized in recent years, involves acquiring selected assets and, at buyer's option, assuming certain liabilities under Section 363 of the Bankruptcy Code. Section 363 permits a streamlined sale process where time is of the essence.

The lead buyer typically signs an asset purchase agreement with the debtor, one that usually lacks any meaningful representations or warranties and that requires court approval. As a condition to such approval, there must be publication and notification of other potential buyers who can come in and top the stalking horse buyer's bid. The lead buyer can seek

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protection by negotiating and having the court approve a break-up fee of 3% or so, but there is no assurance that the deal will close, notwithstanding a substantial investment of time and money.

Also, another approach involves the purchase of assets as part of the debtor company's plan of reorganization in Chapter 11. Advantages over a Section 363 sale include the fact that it allows for payment of consideration other than cash (e.g., equity, debt, etc.), greater finality and a better opportunity to preserve company tax benefits. However, it is typically more expensive and more time-consuming, requires DIP financing (of which little is available these days) and carries a greater risk of being "nickel and dimed" by creditors, since a majority of each class of creditors in number and two-thirds in amount must generally approve the plan.

Given the multiplicity of alternative approaches for effectuating a distressed acquisition, and given the wide variety of possible circumstances, detailed planning and thoughtful strategizing are critical to success.

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