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Client Alert

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Bankruptcy Auctions: The New Buyout Market?

What is a private equity firm to do in the current leverage constrained market? The days of bidding up the prices of profitable and growing businesses in robust auctions fueled by stapled financing featuring PIK/toggle covenant light terms at 7x EBITDA are a thing of the past. The debt crisis has largely eliminated the availability of debt financing for LBO transactions and owners of healthy businesses are holding their properties off the market rather than attempting to gain liquidity against the headwinds of wounded private equity buyers and introspective lenders. Obviously, many private equity professionals are devoting a significant amount of their time and energy nursing the hangovers in their own portfolios from many of these deals. But for the more intrepid PE professionals with dry powder, there may be an opportunity to pick through the carnage created by the debt bubble of the early part of this century and turn some of the lemons into lemonade.

In the current market, opportunistic PE firms may be able to capitalize on industry-specific deal research and/or company-specific due diligence completed during the boom to realize the value in strong operating companies' financial statements stressed under the weight of excess leverage and weakened consumer demand. The auction process in this new world order may be in the form of sales pursuant to Section 363 of the Federal Bankruptcy Code. In a 363 sale, a debtor in bankruptcy can sell its assets, which constitute either substantially all of the debtor's business or discrete business units, in a transaction supervised and approved by the Bankruptcy Court. The purchaser buys the identified assets free and clear of most creditors' claims, with the ability to pick and choose which of the debtors contracts to assume and often the leverage to renegotiate deals with suppliers and customers in the process. While 363 sales involve a great deal of bankruptcy-regulated process, including an auction process to assure that the debtor's estate has maximized value, sophisticated investors can construct sensible transactions to acquire fundamentally sound businesses and, in certain cases, successfully structure the consideration offered in their bid to include a mix of equity and debt securities with the effect of leveraging the acquired business.

Although private equity firms have traditionally avoided turn-around situations and navigating the bankruptcy process can be intimidating, this sharp economic decline may present a unique opportunity to move outside of a firm's comfort zone to take advantage of some significant values. Moreover, by taking a thoughtful approach to the market, PE firms have the ability to execute on some of these transactions without inordinate risk.

This client alert highlights some of the opportunities and strategies to consider when approaching this market and some of the technical aspects of the process that should be considered.

Second Look Strategy

Ideally, a PE fund can capitalize on its unique knowledge of a distressed situation to manage the 363 process to its advantage and structure a favorable deal. An obvious example arises where the fund participated in a prior auction of the distressed company which resulted in the transaction that left the acquired company overleveraged and led to its insolvency. In these situations, the PE firm can take advantage of its original due diligence to quickly evaluate (i) challenges imbedded in the target's capital structure which led to the business' distress, (ii) prospects of the core business to turn around if properly recapitalized, (iii) strengths and weaknesses of incumbent management and (iv) adjustments required to properly capitalize the business. The PE fund may well have interacted with the company's creditors and be in a position to potentially conduct a three-party negotiation with the debtor and its lead creditors to craft a plan which includes offering a package of debt and equity to the estate to provide appropriate leverage for the business as it is purchased out of bankruptcy.

Play to Your Strengths

The 363 process takes place in a dynamic and rapidly changing environment; the debtor's advisors will typically engage in a marketing effort to create a robust auction, the company's financial condition may be changing rapidly as cash is constrained, vendors and customers may withdraw their business and employees may jump ship. Buyers will generally have access to an offering memo and a data room for due diligence, but in such a rapidly changing environment and under strict time constraints, the prospective buyer is well advised to look for transactions in industries where the fund has particular expertise so as to anticipate, address and avoid missteps. This will enable the prospective acquirer to evaluate the damage that has been done to the business and call upon its experience, credibility and relationships to plug financial and managerial leaks and repair the frayed relationships with customers and vendors. As the 363 process unfolds, it is essential to evaluate changing circumstances and react in real time.

Entering the Fray

Prospective acquirers should consider when to disclose their interest, or at least the level of their interest, in the target. If the prospective purchaser comes forward before the commencement of the 363 sale process or, in some cases, even before the bankruptcy proceeding, the prospective purchaser will have an opportunity to confer in advance with the debtor, its creditors and their advisors over the terms of a proposed transaction. This will enable the prospective purchaser to update its due diligence and assess the current state of the business. The prospective purchaser can explore the debtor's appetite for accepting debt and/or equity securities in the proposed transaction in lieu of, or in addition to, cash as a means to leverage the company in the sale transaction without having to locate new lenders in the current anemic debt market. Discussions with the debtor would also identify the expectations of the key creditor constituencies for working capital levels required for the business once recapitalized. By entering the fray early, the prospective bidder can gain a considerable upper hand over competing bidders because it will (i) have substantially completed the due diligence of the troubled assets prior to the

commencement of the auction; (ii) be in a position to negotiate the consideration, resultant capital structure and various buyer protections for inclusion in the asset purchase agreement; and (iii) along the way develop strategic relationships with the central players in the bankruptcy. The question for a prospective purchaser is whether being the stalking horse will get the purchaser greater certainty and/or the best deal terms?

To Stalk or Be Stalked?

The Section 363 sale process often involves a “stalking horse” bidder selected by the debtors. As with any auction process, debtors generally believe (and experience corroborates) that the presence of a stalking horse bidder generally yields greater value than an open auction (known as a “naked” 363 sale). Potential purchasers must evaluate whether they are better served by taking the role of the stalking horse bidder or if it would be more advantageous to enter the auction process later to outbid the stalking horse. In exchange for the stalking horse’s investment in due diligence and negotiating the purchase agreement (thereby establishing a price floor for the debtor’s auction), the stalking horse can generally negotiate (i) the terms of the auction procedures, including important timing milestones and bidding increments, (ii) the payment of a break-up fee and/or expense reimbursement and (iii) the form of consideration to be paid for the assets which may include an issuance of equity and/or debt securities to the estate (the payment of which effectively operates as an exchange offer to prior creditors). However, it may also be advantageous for the prospective purchaser to hold its cards to see if other bidders emerge and react to another bidder’s offer when the bidding commences. This decision may turn, in part, on whether the bidder can strike a deal with the debtor and its key creditors to acquire the target in a structured transaction involving a mix of debt and equity rather than a cash deal. On one hand, it may be beneficial to proactively initiate the bidding on terms structured by the stalking horse, however, circumstances may make it more advantageous to wait on the sidelines with cash and see how the bidding process develops. Either way, the decision to stalk or be stalked involves a careful assessment of the debtor, its key creditors and the other potential purchasers of the target assets.

Fund the DIP?

Another threshold consideration is whether the debtor can fund its operations during the time that may be required to conduct the 363 sale process. The debtor will typically require a new credit facility, known as DIP financing, to fund its operations while in bankruptcy. A prospective bidder may find it advantageous to offer to provide the DIP financing in order to gain additional insight into the debtor’s financial position and operations during the pendency of the case. When the stalking horse bidder provides the DIP, it can avoid the natural conflict between the interests of a stalking horse bidder and a DIP lender over break-up fees, expense reimbursement and bidding procedures, which will enhance the security for the DIP facility and the pay-out to the stalking horse in the event it is not the successful bidder.

Navigating the Court Approval Process

In a 363 sale the asset purchase agreement will be similar in many respects to a non-bankruptcy agreement, but will contain specific provisions relating to the bidding procedures that will govern the Section 363 auction and sale process as well as negotiated buyer protections – each of which will be reviewed by the court and ultimately rejected, modified or approved by the bankruptcy judge assigned to the case. A bankruptcy court has substantial discretion to conduct a sale in the manner it deems most appropriate to facilitate the fair sale of the debtor's assets and to maximize the value of those assets for the benefit of the estate. In evaluating the bidding procedures, a court will consider a variety of factors, including, but not limited to, the pre-filing efforts of the debtor to pursue potential bidders, whether the proposed buyer is an "insider" and whether the procedures operate to "chill" the auction process. In addition to the bidding procedures, the court will evaluate any buyer protections negotiated by and agreed to with a stalking horse in exchange for the time and expense committed to negotiate the deal in the face of the risk of being outbid. These buyer protections may include "break-up" fees, "topping" fees and expense reimbursements to cover the costs associated with conducting due diligence and negotiating the sale documentation. Not all buyer protections may survive the scrutiny of the bankruptcy judge. The tests for determining when stalking horse fees are appropriate in the bankruptcy context vary from court to court and, in some cases, the temperament of the judge assigned to the particular case.

The Hidden Costs of Diligence

Once the bidding procedures are approved by the court, the time frame for diligence by other interested parties and competing bids will be limited. While Section 363 sales ideally take place pursuant to an organized and managed sale process, in some cases, because of the debtor's business distress and limited resources, information is incomplete and the time frame for the process is compressed. Although a stalking horse's due diligence can be expensive and time consuming and the stalking horse always faces the risk of being outbid, in a Section 363 sale the advantages of a head-start on diligence are considerable. In particular, the Bankruptcy Code permits the debtor to assume and assign selected executory contracts to the buyer in connection with the sale. For a contract to be assigned, the Bankruptcy Code requires that the debtor cure all payment defaults under the assumed contract. The "cure costs" associated with these selected contracts are a considerable sticking point between the debtor and the buyer, as the cure costs ultimately affect the value of the deal and need to be adequately accounted for either through payment by the debtor from the proceeds of the sale or an adjustment to the purchase price. It is critical that a buyer understands the scope and timing of any "cure costs" so that proper mechanics can be built into the asset purchase agreement to allocate payment by the appropriate parties.

Work with Existing Management

It is vital for potential buyers to work closely with the debtors' executives and senior management during the Section 363 sale process. Not only is management key in determining which tangible assets will be of value to the business post-closing, but they can also provide considerable guidance on the selection of

contracts to be assumed and assigned to buyer. Further, the management team has relationships with the counterparties to the debtor's contracts and may help to facilitate negotiations for more favorable terms with such counterparties who will likely consider revising the contract in the face of the possibility of rejection and being left with only an unsecured claim against the debtor's estate.

Understanding the Risks of "Free and Clear"

One of the greatest appeals of a Section 363 sale is that a debtor is able to transfer the assets to the buyer "free and clear" of any existing interests. While it is clear that "interests" includes claims to title, liens, mortgages and security interests, there is ambiguity as to whether "interests" also incorporates claims such as fraudulent conveyances, employment discrimination or product liability. Most exposure for "successor liability" – the buyer being liable as successor of the debtor's business – can be eliminated if the bankruptcy process and paperwork is done effectively. Notice of the sale and its potential effect on the claimant and notice of the bankruptcy and the right to file a claim against the debtor are essential if claims are to be eliminated. Protection against future claims for product liability for a buyer which continues the debtor's business is more problematic. A buyer is best served by obtaining adequate product liability insurance to cover any potential claims, especially if the acquired assets present considerable exposure to product-related liabilities.

The goal of the purchaser at a Section 363 sale is to take advantage of the financial distress of the debtor and the power of the Bankruptcy Code to make a safe, profitable investment. While a Section 363 sale is a complex exercise for the unwary, it can be an efficient avenue for a well-prepared buyer to acquire a financially troubled business.

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