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Weil News

- Weil Gotshal was nominated by Financial News Legal Awards for Private Equity Team of the Year
- Weil Gotshal was nominated by Real Deals/EVCA European Private Equity Awards for Legal Adviser of the Year
- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the sale of its 45% stake in hedge fund R3 Capital Partners
- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the sale of Eagle Energy Partners I, L.P. to EDF Trading North America
- Weil Gotshal advised Natixis Investissement Partners in connection with its sale of Aerocan France SAS to Barclays Private Equity France
- Weil Gotshal advised Stone Tower Equity Partners in connection with its acquisition of a 25% stake in TowerCo, a consortium formed to acquire cell towers from Sprint Nextel Corporation

Buying Assets out of Bankruptcy in the US and the UK

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The current market environment presents opportunities for private equity buyers to purchase assets at discounted prices. While financially distressed sellers may be willing to quickly sell assets to stay afloat, the distressed nature of such sellers heightens deal uncertainty. Bankruptcy sales offer certain protections to both buyers and sellers in this situation, so private equity firms should evaluate the applicable bankruptcy laws when determining whether, how, and at what price to purchase these assets.

The US Perspective

Heightened Areas of Risk

An acquisition of assets from a financially distressed seller has all of the risks typically associated with the purchase of assets from a seller that is not financially distressed. But if a seller is insolvent or rendered insolvent as a result of the purchase of those assets, the buyer is exposed to the additional risks of having a previously completed acquisition of purchased assets avoided as a fraudulent transfer, or having the seller reject the uncompleted purchase agreement in a bankruptcy filing made prior to the closing.

Avoidance of Purchase as a Fraudulent Transfer

The primary risk in the purchase of assets from a financially distressed seller is the fraudulent transfer concern. Fraudulent transfer law prohibits a company from transferring its assets to a third party if the company has the intent of preventing its creditors from reaching such assets or if the company does not receive reasonably equivalent value for such assets and the company is either insolvent or rendered insolvent as a result of such transfer. The fraudulent transfer risk can arise whether or not the seller subsequently files for bankruptcy, as applicable state laws allow the creditors of an insolvent company to recover assets fraudulently transferred from the debtor. The purchaser who acquired the assets in a fraudulent transfer would be forced to return the assets so acquired and have nothing but an unsecured claim for a return of the purchase price paid for such assets against the seller.

While applicable state law empowers courts to avoid fraudulent transfers even in the absence of an actual bankruptcy filing, fraudulent transfer claims are most commonly made in the context of a bankruptcy filing. After the seller files for bankruptcy, the Bankruptcy Code empowers the trustee or debtor-in-possession to avoid fraudulent transfers under both state law and federal bankruptcy law, the latter of which requires proof of actual or constructive fraud. Actual fraud includes the intent to hinder, delay *or* defraud creditors and is often proved through circumstantial evidence, including certain "badges of fraud" such as the lack of adequate consideration, or the seller's financial condition before and after the transaction. Constructive fraud requires that the debtor receive less than "reasonably equivalent value" for the transferred assets, plus proof that one of the four conditions of Section 548(a) of the Bankruptcy Code is satisfied. The two most common conditions are that the debtor was insolvent at the time of the sale or became insolvent as a result thereof or the sale left the debtor with unreasonably small capital to conduct its business.

Buying assets from a distressed seller that has actually filed for bankruptcy offers significant protections not available outside the bankruptcy process.

The determination of a fraudulent transfer is a fact-driven inquiry that depends on the particulars of the transaction. A private equity firm buying assets at a discount from a company that is or may become insolvent should be concerned as to whether the price is considered to be "reasonably equivalent value." This standard does not explicitly require a finding of good faith but some courts have included an element of good faith in their overall analysis. Other courts have looked at factors such as the fair market value of the property at the time of sale, the marketability of the property and the level of interest from potential buyers. If the bankruptcy court finds that a sale of assets constitutes a fraudulent transfer, then it can permit the debtor to avoid a transfer made within *two years or more* before the bankruptcy filing. As an appropriate remedy, the court can require that the purchaser return either the acquired assets or the value of such assets. While the purchaser can assert a good faith defense, a fraudulent transfer claim can put a cloud over the finality of the sale for months, or even years.

Rejection of Purchase Contract

A buyer is presented with additional risks if the seller files for bankruptcy after the purchase agreement has been signed, but before the transaction has closed. Under the Bankruptcy Code, a debtor can reject executory contracts such as the purchase agreement which require future performance by both parties. The debtor's rejection of the contract is considered a breach of the purchase agreement immediately prior to the bankruptcy filing. The debtor is excused from performance under the purchase agreement and the buyer is left with a pre-petition breach of contract claim based on the rejection. The buyer will be left with an unsecured claim and be at the bottom of the pile of creditors seeking recovery from the debtor.

Possible Avenues of Protection Outside of Bankruptcy

The most effective way to counter a fraudulent transfer claim is to prove that the purchase price was close to the fair market value of the acquired assets, through a third party appraisal or otherwise, but this strategy may not be available if the assets are purchased at a deep discount. The buyer can try to protect against the possibility that the seller will be insolvent or undercapitalized after the sale by requiring the seller to make related representations and warranties in the purchase agreement. However, if the seller subsequently breaches these representations and warranties and files for bankruptcy, then the buyer will only have a pre-petition breach of contract claim, which has limited value. If the buyer is purchasing assets from a solvent subsidiary, then it can try to ensure that the seller's parent has "ring-fenced" the subsidiary so that it is not subsequently included in the parent's bankruptcy filing. But ring-fencing is one of many factors considered in a substantive consolidation analysis and may not offer sufficient comfort to buyers.

Protections Offered by Bankruptcy Sales

Buying assets from a distressed seller that has actually filed for bankruptcy offers significant protections not available outside the bankruptcy process. Specifically, the purchase of assets from a seller pursuant to a Section 363 sale or a bankruptcy plan offers protections against fraudulent transfer concerns and contains additional benefits for private equity buyers. Section 363 sales (named for a section of the Bankruptcy Code) are typically used for asset sales whereas a bankruptcy plan covers the debtor's entire business. Because bankruptcy sales differ from traditional M&A transactions in certain respects, private equity buyers should familiarize themselves with the pros and cons of the bankruptcy process for each potential transaction.

Elimination of Fraudulent Transfer Concern

After the seller files for bankruptcy protection, it has a fiduciary duty to obtain the "highest and best" offer for its assets and may only complete a sales transaction after receiving bankruptcy court approval. The procedural and substantive requirements of the Bankruptcy Code essentially eliminate the possibility of the sale being subsequently avoided as a fraudulent transfer.

Additional Benefits for Buyers and Sellers

One of greatest advantages of buying assets from a financially distressed seller through a 363 process is that the sale order can specify that the assets being transferred to the buyer are free and clear of most liens, claims or encumbrances if one of the five conditions in Section 363(f) of the Bankruptcy Code is satisfied. The most common condition is that the liens can be reduced to a claim for money, in which case the liens attach to the proceeds of the sale and the assets are transferred free and clear of such liens.

An additional benefit for private equity buyers is the ability of the seller to assume or reject executory contracts and assign assumed contracts to the buyer regardless of anti-assignment language. The rejection power can be enormously beneficial to the buyer because the buyer can help the seller determine which contracts to assume or reject. To transfer the contract to the buyer, the seller must first assume the agreement and cure any outstanding defaults or provide adequate assurance that they will be promptly cured. Then the seller can assign the agreement to the buyer, who must also provide adequate assurance that it can perform the ongoing obligations under the contract. This rejection or assumption option can facilitate agreement on issues that are often the subject of intense negotiation in M&A transactions because the seller is able to reject contracts that are considered disadvantageous to the business.

A Section 363 sale order also offers benefits to the seller. If the distressed assets are sold at a low price, then the seller's directors and officers may be concerned that its creditors or shareholders will contest the terms of the transaction. The bankruptcy court's approval of the sale protects them from future litigation regarding the price or fairness of the sale.

Bankruptcy Concerns

Notwithstanding the benefits described above, some buyers and sellers may be reluctant to participate in a bankruptcy sale for several reasons, including the time and expense involved in a bankruptcy filing and unfamiliarity with the process.

First, a bankruptcy filing involves an enormous amount of resources from the seller as a debtor in bankruptcy. It is critical for the debtor to pro-actively manage the process to minimize disruptions and avoid the deterioration of its assets.

Second, the bankruptcy approval process involves more parties, which can delay or hinder possible sales transactions. In addition to negotiating with the potential purchaser, the debtor must obtain the consent of the creditor's committee and the bankruptcy court, and possibly a court-appointed trustee or members of its secured banking group.

Third, the requirement to obtain the "highest and best" offer for the assets requires that the debtor either hold a public auction or make a private sale subject to other offers. Even if the seller can negotiate a stalking horse contract with the buyer which contains certain deal advantages such as a break-up fee, the buyer may not be willing to risk that its offer can be topped by other bidders.

Fourth, the parties may not want the terms of their transaction to be publicly disclosed. The bankruptcy court filings are publicly available so the terms of the stalking horse contract and the winning bid will be filed with the bankruptcy court.

Best of Both Worlds: Prepackaged and Prearranged Bankruptcy Sales

Buyers who are interested in purchasing all or substantially all of a seller's assets may benefit from the best of both worlds by conducting a prepackaged or prearranged bankruptcy, which involves a bankruptcy plan of reorganization instead of a Section 363 order. A bankruptcy plan offers more financing and structuring options to buyers but normally takes more time and expense than a Section 363 sale since the debtor must distribute a written disclosure statement containing adequate information about the plan to all interested parties and the requisite creditor groups must approve the plan.

A prepackaged or prearranged bankruptcy significantly shortens this timeframe by conducting most of the work prior to the bankruptcy filing. In a prepackaged bankruptcy, the debtor prepares the disclosure statement and obtains the requisite approvals from its creditors before filing for bankruptcy. In a prearranged bankruptcy, the plan is negotiated prior to the bankruptcy filing but the votes are taken and the disclosure statement is completed after the bankruptcy filing. Both scenarios take considerable negotiations between the seller, buyer and creditor groups prior to the filing but enable the sales to be consummated quickly once the filing is made. Most importantly for private equity buyers, prepackaged or prearranged bankruptcy plans significantly reduce the deal uncertainty associated with bankruptcy sales since they eliminate the need for auctions yet retain the protections offered by a bankruptcy sale.

UK Comparison

As in the United States, the purchase of assets from a distressed seller in the United Kingdom offers certain advantages for a private equity buyer. For example, buyers can select which assets of the distressed seller they wish to purchase and can expect to acquire such assets at a discounted price. Whereas a seller can conduct its asset sales as a debtor-in-possession in the United States, sales in the United Kingdom, where the seller is in insolvency proceedings, are conducted either by an administrator, if the company is still a going concern, or by a liquidator, if it has ceased trading. The UK courts do not have a role in approving such sales.

Similar to US bankruptcy law, UK insolvency law enables sales to be avoided if the assets are sold at an undervalue. The UK Insolvency Act 1986 permits administrators and liquidators to challenge a transaction entered into by an insolvent company in the two year period before it became insolvent if the value received by the seller was significantly less than the value given to the buyer. In addition to proving undervalue, the administrator must demonstrate that the company was insolvent, or became insolvent, as a result of the transaction, or that the company had a specific intention of putting assets beyond the reach of creditors (in which case there is no limit on the look-back period).

As in the United States, the most effective protection against an undervalue claim is proof that the purchase of assets was made at market value through independent valuations of the assets prior to the transaction. If the buyer purchases assets from a seller in insolvency proceedings this will provide protection from any subsequent undervalue claims as the insolvency office-holder will have had the conduct of the sale.

While a buyer of assets from a distressed seller can select which assets to acquire, UK insolvency law does not enable a debtor to assume or reject executory contracts and the commencement of insolvency proceedings does not prevent counterparties from terminating their contracts with the seller. As a result, the value of the debtor's business can rapidly deteriorate after it enters formal insolvency proceedings. Buyers and sellers are increasingly managing this risk by selecting to do a prepack administration, which is similar to a US prepackaged bankruptcy. The buyer, seller and administrator agree the terms of the sale prior to commencing administration proceedings and then formally implement it. This strategy creates less disruption to the seller's business and maximizes its on-going value. While creditors could challenge the administrator's conduct of the sale if there is evidence of prejudice, such challenges are very rare in practice.

Similar to the US, sellers in UK insolvency proceedings will decline to give warranties and any claims made pursuant to the terms of the sale contract would be unsecured claims against the insolvent company. Since UK sale orders cannot specify that assets be transferred to buyers free and clear of most liens, claims or encumbrances, buyers should conduct sufficient diligence regarding the assets and ensure that the purchase price adequately factors in the risk of defects in title and other liabilities. In the UK (and elsewhere within the European Union) where a business or part of it is sold as a going concern, whether or not through formal insolvency proceedings, statutory provisions operate so that the buyer automatically takes on ongoing responsibility for employees in that business. A significant part of the due diligence will therefore be to evaluate the extent of employee liability.

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For more detailed information about US bankruptcy 363 sales, see "Yesterday's Auctions Today: 363 Sales" by Glenn D. West and Stephen A. Youngman, at www.weil.com.

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