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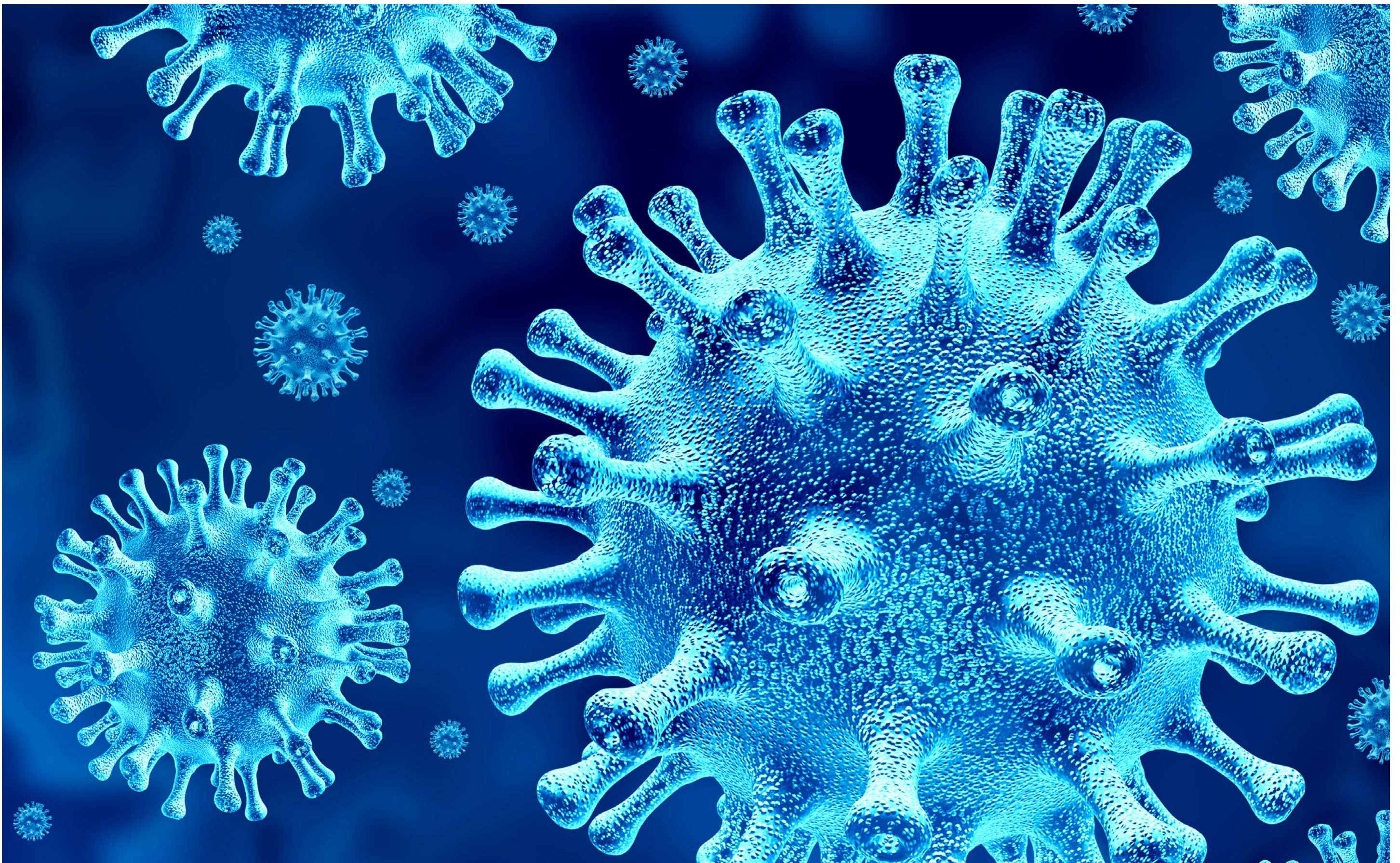

The Art of the (Bad) Deal – An Overview of Certain Considerations in Distressed M&A Transactions

George H. Singer
Partner, Commercial Finance
612.371.2493
singerg@ballardspahr.com

Chad A. Stewart
Partner, Business and Transactions
612.371.5774
stewartc@ballardspahr.com

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No one would have guessed six months ago that we would be battling a global pandemic that would claim the lives of nearly 100,000 people in the United States, force most of the country to "shelter-in-place," cripple global markets, and result in an increase in the unemployment rate to levels not seen since the Great Depression.

Many businesses are now being forced to determine whether they can weather the economic downturn, or whether they should consider a sale to maximize value for stakeholders. In this environment, some companies with meaningful financial resources will focus their efforts on managing their businesses through this crisis and delay a sale process until more certainty prevails. Other companies with thinner resources, particularly those in industries hit especially hard by the effects of COVID-19, will have fewer options and may determine that selling is the best (or only) option available to maximize value for stockholders and other constituencies.

Distressed companies can be attractive acquisition targets, as their values often reflect the difficulties they face. It is not hard to imagine that the circumstances surrounding COVID-19 will lead to (1) an unprecedented wave of distressed M&A transactions and (2) a meaningful shift of relative bargaining power to favor buyers (in contrast to the last 10+ years where sellers have generally enjoyed a stronger negotiating position). A distressed environment impacts both the way in which deals get done and the considerations that influence the execution of transactions.

This article will briefly discuss some key considerations in distressed M&A transactions, some of which will be explored in greater detail in future articles in our "The Art of the (Bad) Deal" series.

Structure. Buyers will generally prefer asset acquisitions in a distressed environment in order to select the assets of interest and leave behind as much of the seller's liabilities as is possible. Asset deals can, however, be complex and increase the execution risk due to the necessity of third-party consents that may be required to transfer leases, licenses and other material contracts. In situations where a stock deal (including a merger) cannot be avoided, buyers may negotiate to require the target company to restructure prior to the closing to shed undesirable assets or liabilities.

Successor Liability. As a general rule, the buyer in an asset deal is not responsible for the seller's liabilities unless specifically assumed in the asset purchase agreement. There are, however, situations where a buyer may be held responsible for the seller's liabilities, even liabilities for which the seller agreed to remain responsible. More specifically, some courts have held a buyer responsible for the seller's liabilities where: (1) the buyer assumed the liabilities (either expressly or impliedly); (2) a de facto merger was found to have occurred; (3) the transaction was found to be fraudulent or designed to avoid liability for the seller's obligations; or (4) the buyer was found to be a mere continuation of the seller. Some courts have also expanded the traditional scope of successor liability and found that liability can be imposed where there is a continuity of enterprise (rather than only ownership) and in some product liability cases where the new company continues to produce the same product line. State law matters,

as courts in some states (such as Delaware) are reluctant to hold a buyer responsible for a seller's liabilities that are not expressly assumed in the transaction, absent a finding of fraud or insufficient consideration having been paid for the acquired assets. Further, in certain states, including Minnesota, state lawmakers have taken action to provide buyers more certainty that they will not be held responsible for a seller's liabilities they did not agree to assume.[1] Regardless of the state law that applies, the possibility of successor liability highlights that buyers should identify and quantify risk by performing due diligence and negotiate an indemnification package that affords the buyer a real opportunity to recover any damages it incurs (which may include securing a representation and warranty insurance policy—see discussion below under "Indemnification"). Buyers should also consider requiring the seller to purchase tail coverage under claims-made insurance policies as a condition to closing the transaction.

Fiduciary Duties – Insolvency & Zone of Insolvency. Directors of companies experiencing financial difficulties need to keep in mind that the stakeholders to whom they owe fiduciary duties expands when the company is insolvent, or even approaching insolvency. When a company is insolvent—meaning it is not able to pay its creditors in full—directors continue to owe fiduciary duties to the company, but creditors replace stockholders as the primary beneficiaries of those duties. A number of courts have suggested that directors' fiduciary duties actually expand to include creditors at an indeterminate point in time before the actual insolvency of the corporation when a business is in financial distress (also known as the "zone of insolvency"). Directors therefore should also consider the interests of creditors once the corporation is in financial distress or approaching insolvency.[2]

Section 363 Sales. A section 363 sale is a process by which a company in bankruptcy may sell a portion or substantially all of its assets, generally in a competitive process, to try to maximize value. At a very high level, the process works as follows: (1) the debtor enters into an asset purchase agreement with a stalking horse bidder, the closing of which is conditioned on, among other things, receiving bankruptcy court approval; (2) the debtor provides notice to creditors of a hearing at which it will ask the bankruptcy court to approve the sale process; (3) if the bankruptcy court approves the sale process, there often is a formal auction, pursuant to which qualified bidders have the opportunity to submit higher bids to ensure that the debtor is maximizing value for the assets to be sold; (4) following the auction, the final documents are submitted to the bankruptcy court for approval; and (5) the bankruptcy court enters a sale order approving the transaction. There are many advantages and disadvantages to a section 363 sale.

Certain *advantages* include that:

- the buyer in a 363 sale acquires the assets free and clear of liens, claims and interests and, as a result, can be more efficient in performing due diligence and worry less about post-closing exposure;
- the buyer can limit the risk of inheriting some or all of the business's liabilities, a possibility that would be subject to greater risk outside of bankruptcy;

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1 *See* MINN. STAT. § 302A.661 subd. 4 (providing "[t]he transferee is liable for the debts, obligations, and liabilities of the transferor only to the extent provided in the contract or agreement between the transferee and the transferor or to the extent provided by this chapter or other statutes of this state. A disposition of all or substantially all of a corporation's property and assets under this section is not considered to be a merger or a de facto merger pursuant to this chapter or otherwise. The transferee shall not be liable solely because it is deemed to be a continuation of the transferor.").

2 Ballard Spahr alert: Director Fiduciary Duties – Navigating Financial Distress During COVID-19

- the bankruptcy sale process eliminates fraudulent transfer claims because the court-supervised auction process is approved by order, thereby ensuring that the transaction is not attacked by a claim that the debtor received less than "reasonably equivalent value" for the assets sold;
- the buyer generally has the ability to assume or reject the debtor's contracts and thereby "cherry pick" the agreements it wants, and does not have to obtain third party consents for most transferred contracts because anti-assignment clauses generally are not enforceable in bankruptcy; and
- the seller can consummate a sale transaction in bankruptcy that would otherwise require the approval of stockholders or other interested parties whose consent would be required under state law.

Certain *disadvantages* to a 363 sale include that:

- the process is often competitive and, because there typically are a number of interested parties (each fighting to get as much out of the process as possible), the 363 sale process can be chaotic and increase the price beyond what a buyer would expect to pay in a sale outside of bankruptcy;
- everything plays out in public in bankruptcy—this fact, along with the bankruptcy filing itself, may have a negative effect on the seller's business operations;
- no bidder has any guarantee that it will be the successful bidder, yet each bidder must incur meaningful expense to participate in the process;
- the representations and warranties in a 363 sale generally do not survive closing and buyers often have no right to indemnification following the closing (although representation and warranty insurance, discussed below under the heading "Indemnification", may be considered to help mitigate this issue); and
- a sale outside of bankruptcy can often be accomplished more quickly and economically than a bankruptcy sale.

Article 9 Sales. When a borrower defaults on an obligation to a secured creditor, Article 9 of the Uniform Commercial Code allows that creditor to take possession of and foreclose on the collateral that is subject to the creditor's security interest, subject to the requirement that the secured creditor sell it in a "commercially reasonable" manner.[3] The proceeds from such a sale are generally distributed in the following order: (1) to cover reasonable costs and expenses of the foreclosure; (2) to satisfy amounts owing to the selling secured creditor (or to any creditor with a lien senior to the selling secured creditor); (3) to satisfy amounts owing to junior secured creditors; and (4) to return the then-remaining amount (if any) to the debtor. Because the buyer in an Article 9 sale is buying assets from a secured creditor, as opposed to the company operating the business, buyers generally acquire the assets from the secured creditor on an "as-is, where-is basis," which means the buyer must rely more heavily on its due diligence review or simply decide to take more risk. Further, the buyer in an Article 9 sale needs to be mindful that, if the proceeds from the transaction are insufficient to pay unsecured creditors (including trade creditors), those creditors could force the debtor into an involuntary bankruptcy following the closing of the transaction. Under those circumstances, the sale transaction may be scrutinized during the bankruptcy proceeding and subject to attack on the basis that the secured creditor did not receive "reasonably equivalent value" for the

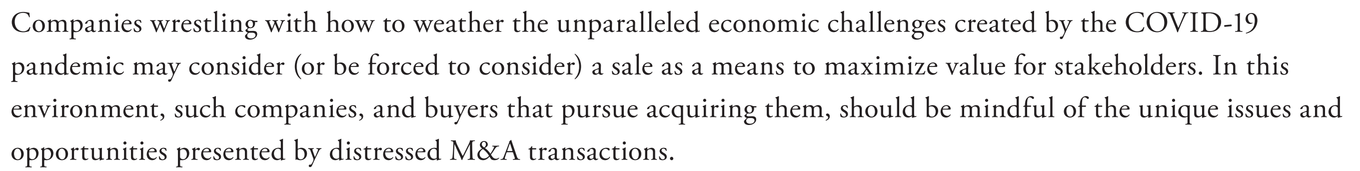
3 *See* Uniform Commercial Code § 9-610 (providing "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.").

assets or that the disposition was not "commercially reasonable." The major advantages of an Article 9 sale are the simplicity of the process, the speed at which it can be accomplished and the limited costs associated with execution. Additional comfort can be provided to help mitigate risk if the foreclosure transaction is a "friendly foreclosure" that is accomplished with the debtor's consent and cooperation.

The Importance of "Reasonably Equivalent Value." Buyers of distressed assets outside the section 363 sale context need to be mindful that their transaction may not be respected if the seller voluntarily or involuntarily files for bankruptcy following the closing of the transaction. More specifically, transfers made within two years prior to a bankruptcy filing (or sometimes longer under applicable state law) may be "avoided," meaning unwound, if the seller received less than "reasonably equivalent value" and was insolvent at the time of the transaction (or became insolvent as a result of the transaction). There is no definitive definition of "reasonably equivalent value" —it requires consideration of all the facts and circumstances surrounding the sale—but courts generally are trying to determine whether fair value was received for the assets transferred. To support that "reasonably equivalent value" is being provided, buyers in certain distressed transactions should consider requiring that the seller's board of directors obtain a fairness opinion from an independent financial advisor that the consideration to be paid in the transaction is, in the parlance of fairness opinions, "fair from a financial point of view."

Trade Creditors. The above discussion relating to Article 9 sales and "reasonably equivalent value" underscores that parties to distressed transactions should consider carefully how trade creditors will be impacted by the transaction. Unless provision is made to ensure that trade creditors are being paid in full, practical business considerations may require the buyer to expend additional capital following the closing as an investment in the ongoing relationship with those trade creditors. For example, if there are few suppliers of a particular product in the marketplace, the buyer may have no choice but to continue buying from a particular supplier following the closing, in which case the buyer may be forced to make some accommodation to that supplier, whether or not the buyer is legally obligated to do so.

Indemnification. Buyers in distressed transactions often acquire the subject business at attractive prices relative to what they would pay in a "healthy deal," but they also often receive less in the way of contractual protection. In a 363 sale, the representations and warranties typically do not survive the closing. In an Article 9 sale, the secured creditor will make very few, if any, meaningful representations and warranties relating to the assets sold, leaving buyers to rely more heavily on their due diligence review. In a distressed transaction outside of a section 363 sale or an Article 9 sale, while buyers may receive fairly robust representations and warranties and have the right to be indemnified following the closing, having a contractual right to indemnification is different than actually being able to collect on an indemnification claim. As a result, buyers may insist on various forms of security to help ensure that funds are available to satisfy post-closing indemnification claims, which may include escrows, holdbacks, deferred payments and set-off rights. Finally, certain distressed transactions may be good candidates for representation and warranty insurance—buyers in those transactions may view this insurance product as a good tool to mitigate risk, and sellers in those deals may view it as a good way to maximize value. Since the last economic downturn, representation and warranty insurance has become widely used in M&A transactions, especially in private equity deals (and, more recently, increasingly in strategic deals as well). Further, this insurance product has been used more frequently over the last few years in "no-seller-indemnity" deals, which are deals in which the seller has no obligation to indemnify the buyer for breaches of representations and warranties, thereby requiring the buyer to rely exclusively on the representation and warranty insurance policy to recover damages resulting from such breaches.



Companies wrestling with how to weather the unparalleled economic challenges created by the COVID-19 pandemic may consider (or be forced to consider) a sale as a means to maximize value for stakeholders. In this environment, such companies, and buyers that pursue acquiring them, should be mindful of the unique issues and opportunities presented by distressed M&A transactions.

OUR LOCATIONS

ATLANTA
999 Peachtree St., NE, Suite 1000
Atlanta, GA 30309-3915
678.420.9300

BALTIMORE
300 E. Lombard St., 18th Floor
Baltimore, MD 21202-3268
410.528.5600

BOULDER
5480 Valmont Road, Suite 200
Boulder, CO 80301-2369
303.379.2275

DELAWARE
919 N. Market St., 11th Floor
Wilmington, DE 19801-3034
302.252.4465

DENVER
1225 17th St., Suite 2300
Denver, CO 80202-5596
303.292.2400

LAS VEGAS
One Summerlin
1980 Festival Plaza Drive, Suite 900
Las Vegas, NV 89135-2658
702.471.7000

LOS ANGELES
2029 Century Park E., Suite 800
Los Angeles, CA 90067-2909
424.204.4400

MINNEAPOLIS
2000 IDS Center
80 South 8th St.
Minneapolis, MN 55402-2113
612.371.3211

NEW JERSEY
210 Lake Drive E., Suite 200
Cherry Hill, NJ 08002-1163
856.761.3400

NEW YORK
1675 Broadway, 19th Floor
New York, NY 10019-5820
212.223.0200

PHILADELPHIA
1735 Market St., 51st Floor
Philadelphia, PA 19103-7599
215.665.8500

PHOENIX
1 E. Washington St., Suite 2300
Phoenix, AZ 85004-2555
602.798.5400

SALT LAKE CITY
One Utah Center, Suite 800
201 S. Main St.
Salt Lake City, UT 84111-2221
801.531.3000

SIOUX FALLS
101 South Reid St., Suite 302
Sioux Falls, SD 57103
605.978.5200

WASHINGTON, DC
1909 K St., NW, 12th Floor
Washington, DC 20006-1157
202.661.2200

Ballard Spahr LLP