John Wright: Welcome to Business Better, a podcast designed to help businesses navigate the new normal.

I'm your host, John Wright. For nearly 15 years I was Senior Vice President and General Counsel at Triumph Group, Inc., a global aerospace component supplier. I'm now a member of the Securities and M&A Groups at Ballard Spahr, a national law firm with clients across industries and across the country.

On today's episode, we'll be discussing merger and acquisition activity involving distressed businesses in the wake of the COVID-19 pandemic. To lead the discussion I'm pleased to turn this episode over to my Ballard Spahr colleague, Chad Stewart, who will introduce his guests and take it from there.

Chad Stewart: Greetings to our listeners. I'm Chad Stewart. I'm a partner in Ballard Spahr's Mergers and Acquisitions Practice Group. Very pleased to be here today.

We are in unprecedented times, and clearly in an environment where we are going to see more distressed deals. And that means a lot of opportunities for buyers. And that's what we're here to talk about today.

I'm very pleased to be here today with my partners, Karen McConnell and George Singer, and I'd like to introduce both of them briefly before we jump into it.

Karen McConnell is a partner in Ballard Spahr's Mergers and Acquisitions Practice Group and the Co-Practice Group Leader of our Private Equity Group.

Karen has a wealth of experience in a wide variety of M&A transactions, including deep experience working on distressed M&A deals. Karen's excellent work has been recognized by too many publications to mention here, but they would include Chambers USA and the Best Lawyers in America.

George Singer is a partner in our Bankruptcy Group. George and I have worked together on a number of distress transactions over the years, including the section 363 sale of Polaroid during the last economic downturn. George's tremendous work on behalf of clients also has been recognized by a number of publications, including the Best Lawyers in America and Minnesota Super Lawyers.

So with that, Karen and George, let's jump into it here. We are about eight months into the global pandemic. When it comes to distress companies, tell us a little bit about what you're seeing in the market right now.

Karen McC.: Thanks, Chad. This is Karen. I'm seeing an uptick in M&A activity and investment activity in the distress world. Clients are seeing opportunities to support businesses and save jobs, and are actively making investments and buyout proposals. Deals are getting done, and oftentime quickly. I'm also seeing strong

M&A activity in the non-distressed world. Businesses do seem to be progressing a bit slower in my practice due to travel, work from home, and other restraints but they are progressing.

George Singer: Well, me, on the other hand in the bankruptcy arena, I am seeing a lot and doing a lot of work with lenders. Both on behalf of the lenders and on behalf of borrowers that are facing a substantial amount of problems. It's all of the continuum. You've got some industries, as we all know, that have been heavily affected by COVID matters. I've got a number of clients that are in the aerospace industry, for example, in one way, shape or another, or support that industry. They're having substantial difficulties. And I'm doing a lot of work right now in national retail bankruptcy cases like Brooks Brothers and the like, on behalf of landlords and creditors.

So, over the past eight months, the lenders and landlords have, by and large, been pretty cooperative. They understand that this isn't the typical situation that has been caused by, usually, by mismanagement and matters like that. They understand that in the landlord tenant universe, for instance, that it's not easy to get replacement tenants in these markets, so both lenders and landlords have been, by and large, pretty cooperative so far.

I don't expect that to continue. I think it'll continue through the first quarter but I think there'll be continuing pressures on both of those to try and resolve where things are going. So far, we're doing a lot of stand-still type cases and a lot of work to try and deal with keeping the status quo, kicking the can, if you will. And that's been emblematic of things, why the companies are trying to solve the problem either through M&A activity or through recapitalization or restructuring.

Chad Stewart: Thanks, George. And I would just echo what Karen said. And I think that we have seen a tremendous increase in activity here in the fourth quarter. We've seen sellers trying to get deals done quickly. We are seeing plenty of distress deals but also plenty of healthy deals too.

So George, I want to bring it back to you to talk a little bit about when a distress company decides to sell and how can you help?

George Singer: Well, I think a sale, particularly in this environment, is either through a business decision or through the lender pressure. It's external pressures that are driving it. Even companies with decent and sound business plans are facing pressures from lenders to sell or come up and figure out how to deal with a capital plan. And you've got a number of private equity firms, for example, and current investors, they're reluctant in this environment to raise more capital, so the company has to go through, or feels compelled to go through, a sale process even if no other reason to appease the lender that, "Look, what will be realize in this environment is not as good as going along with management." So the company has a plan but can't raise more capital and/or the amount of capital that's required to execute on the plan exceeds the value of the company. Those are decisions that really drive a sale process.

You also sometimes have investors that are hesitant to bet on incumbent management and so that all those come together and often drive a decision by the company to try and at least explore a sale process.

Chad Stewart: Karen, I want to bring it back to you. And before we jump into some specific types of distressed M&A transactions, I wanted to ask you what you tell your clients about pursuing the acquisition of a distress company.

Karen McC.: Well, all due diligence is important but in the distressed world it's critical to understand the financial situation and the liabilities of the target. Why did the target become distressed? Was it due to unique target issues or was it industry issues or general economic issues? How deep is the distress? What bills is the target plant paying? And how late are they paying them? What liens encumber the assets? Has any litigation been filed? What capital infusion or other actions will be required for steady and then right the ship?

I generally advise clients to buy assets, if possible, to protect against unknown liabilities. I also generally advise clients to expect compressed timeframes because payrolls need to be met, rent needs to be paid. The target may even need a bridge loan to get to closing in the most serious situations.

There's generally more chaos in the distressed world, so I advise clients to expect emotions to run high. And due to distress, there's generally less in the way of meaningful contractual protection that's available to a buyer. The trade-off may be an attractive valuation but this is another reason to understand the liabilities and downsides so you know what you're getting yourself into. You can always consider whether a rep and warranty insurance policy may be available for the transaction but, ultimately, if you can't put a box around the liabilities you'll be assuming, and that box is a comfortable box, and perhaps you recommend bankruptcy or another court solution to the target as the means to effectuate the transaction.

Chad Stewart: Thanks, Karen.

George, I want to talk a little bit about some of the things that buyers in non-bankruptcy transactions or out-of-court transactions need to be mindful of.

George Singer: Well, one of the first things you need to be mindful of is that a transaction that is originally pursued outside of bankruptcy court for a number of reasons, cost and speed and certainty, for instance, may subsequently end up in bankruptcy when the company's assets are sold. And, usually, the buyer isn't picking up all of the liabilities. The company has to decide, "Okay, you know, now that the assets are sold, what do we need to do to wrap things up?" And oftentimes a Chapter 7 bankruptcy follows. So you need to have that lens as a buyer of, "Okay, a Chapter 7 trustee is likely to be appointed." You have a sale transaction that the trustee will be advised of that occurred within a very short period of time following the sale transaction. And the trustee, of course, is going to want to examine the transaction, and who the buyer is, what the marketing process was, how robust was it, to determine whether reasonably equivalent value was achieved.

And, as one of the benefits of buying in this market is getting some attractive pricing, and depending upon the jurisdiction you're in, that invites an opportunity from trustees to determine, "Wait a minute. Let's see if I can apply some pressure on behalf of unsecured creditors to generate value from the buyer," arguing that reasonably equivalent value wasn't achieved, that the deal that was attained was too good. So, that's certainly one lens, is trying to protect yourself from those subsequent arguments from either creditors or a bankruptcy trustee that reasonably equivalent value wasn't obtained. Now, how do you do that?

Well, you try and make sure that you're building a record to be able to respond to those contentions from a trustee and put down those claims as quickly as you can. If you have had a longstanding and robust sale process with multiple bidders, for example, that is something that will inform a trustee or [inaudible] view. If there was an investment banker or a selling agent involved, that's also helpful.

You, oftentimes, depending upon the size transaction that the borrower and the debtor may want to obtain a fairness opinion because often the boards of directors are targets as well for claims saying that they didn't do... not maximize their fiduciary duty and realizing the vast, additional value was left on the table. All of which is easy with hindsight to allege. And so, making sure that you have appraisal information, evaluation information, both if you're the debtor, and the buyer to support an attack on claims is really a premium, quite frankly.

Chad Stewart: So George, you used the term reasonably equivalent value a few times there. Can you put a finer point on that as to what that means?

George Singer: Certainly. When you're buying assets, and certainly the market considerations like a COVID era and things that externally impact price in the value of a company are fine. In other words, you're dealing perhaps with a foreclosure transaction, you're dealing with a distressed debtor, and you're doing some comparison based upon what the value of the assets would be in reference to balance sheet, for example, or reference to normal market conditions. And, if the debtor had more time and didn't conduct a robust sale process, was it just a fire sale that extremely benefited what normal market conditions were approximately if you had time and had a willing buyer and seller and a marketed asset?

Again, I think the marketing process and the importance of a robust sale process that was undertaken mitigates that because you've tested the market. And in a situation where the lender isn't coming off whole, for example, people look at that as a indication of value as well, that lenders are acting in their own economic self-interest, and if there is a deficiency claim to the secure secured lender, that's another testing point, if you will, from a creditor's perspective that a reasonable value was achieved. It doesn't have to be... I mean, it has to be reasonably equivalent. It doesn't have to be dollar-for-dollar, fair-market value. It has to be reasonably equivalent to what would happen in an arm's length transaction where time wasn't a consideration.

Chad Stewart: Thank you, George. And I want to stick with you here and talk a little bit about Section 363 sales. And maybe we could start, if you could just give us basic definition of what a Section 363 sale is.

George Singer: Yeah, that's a sale process that, for whatever business reasons, because of the nature and extent of the liabilities, because of the timing of what other creditor activities occur, that's a sale process that occurs within the confines of a bankruptcy for a supervised sale process. And Section 363 is a section of the Bankruptcy Code pursuant... which the sale process is conducted and the sale order is issued.

It is a great process, or can be a very great process, for selling assets because you've got... You don't really have to need shareholder approval as you do under State law to sell the assets, so you can circumvent the requirement for, or the necessity for, shareholder approval by having the bankruptcy judge approve the sale. And oftentimes, you can maximize value in a bankruptcy sale that's run. And Chad, you will recall that when we did the Polaroid sale we had an initial bid of roughly $42 million, thereabouts, and through the bankruptcy process, which was constructed as an auction process, a due diligence process that occurred over about a three-month span, the ultimate purchase price was about $87 million. So you can certainly maximize value. And one of the real benefits to buyers in connection with a bankruptcy sale process is the order that you get from the bankruptcy court that authorizes the sale free and clear of liens, claims, and encumbrances. That is a very powerful, attractive thing for buyers. And that's, in part, what helps generate some of the value that you wouldn't otherwise be able to proceed because that eliminates a lot of risk.

Chad Stewart: All right.

Karen, I want to bring it back to you here and talk about some of the factors that need to be taken into account in deciding whether to pursue a deal out of court or through an in-court process.

Karen McC.: Well, the amount of debt is critical in this regard, both in terms of absolute dollar amount and in terms of relation to overall value. So the secure creditors are going to pay a key role in determining how a deal is structured and pursued.

The secure creditors get paid first. And so they want their funds quickly, and they want their funds without risk. And oftentimes, they'll step in and have strong opinions on how a transaction should be structured.

And then also, the buyer gets to drive the decision, particularly if there's concern about lingering liabilities and the buyer requires a free and clear order from the court to proceed, as George just mentioned.

Chad Stewart: All right. Thank you.

And George talked about some of the advantages to Section 363 sales. I want to talk a little bit more about those advantages and also the disadvantages.

And so, Karen, I know George mentioned some of them but is there anything else that you'd like to say about the advantages of a Section 363 sale?

Karen McC.: Well, as George mentioned, one of the key advantages is that you can obtain the assets in a 363 sale, free and clear of liens. And here, the key is the term of the sale order that the bankruptcy court approves. If you're lucky enough to be the stocking horse bidder for the sale, you get the right to negotiate those terms. And if you plan to be a bidder in the transaction but you're not the stocking horse, it's critical to carefully review the sales order so you know exactly what it is you're going to get if you're the winning bidder. Bottom line, as a buyer, you have less risk for liabilities of business if you buy the assets out of bankruptcy.

In addition, bankruptcy, as George mentioned, allows you to get a deal done that otherwise might require consents from, not just stockholders, but other interested parties like counter parties to contracts and things like that. So the path to closing through a bankruptcy process may be far simpler.

Chad Stewart: And George, how about the other side of the coin? What are some of the disadvantages to a Section 363 sale?

George Singer: Well, what some of the disadvantages of the process are, most notably, that it's a public process. It is a court-supervised process under which you have multiple people that in constituencies that are part of the process. So unsecured creditors community, for example, secured creditors. So it's not a one-on-one negotiation you have. Ultimately, you need to get the court's approval. Other people in parties and interests have a right to object to the sale, the terms of the sale, and you find yourself often negotiating with multiple people as while you're trying to accommodate and get through the process.

It certainly... It's competitive. And that's the idea from the debtors and the bankruptcy estates process, is to just drive as much value for the asset and its competitive process, and that often works in a way that it's intended to. And as a buyer, a stocking horse, for example, you may not like a lot of competition.

You want to be the only game in town, and that would be the preferred outcome, but that's not how bankruptcy is designed to work. So when you have a competitive price process, the price ends up going up. Representations and warranties don't survive, closing a transaction, and oftentimes you don't get indemnity either.

So it's an as-is, where-is transaction, so a premium is placed on both speed and due diligence in order to make sure that you understand what you're getting and you understand what you're not getting.

Chad Stewart: All right. I want to follow up with both of you and talk a little bit more about being the stocking horse in a Section 363 sale.

Would you prefer, George, to be the stocking horse, all other things being equal?

George Singer: I would. And the primary reason for that is if I've got a client that is interested, and seriously interested, in buying these assets, that the terms of that purchase transaction, the terms of the process under which the assets are sold, can be structured in a way that's most advantageous to you. You can negotiate heavily. That debtor's going to want to... A lot of other bidders... all the time in the world to do due diligence, for example. All the time in the world, they're going to expand the timeframes between the auction and the sale hearing, to all of which is designed to give other bidders that haven't perhaps done due diligence at all, or have done limited due diligence, to have time to get up to speed and do that.

Balanced against that is the need to close expeditiously and, from the stocking horse's desire, is, "You know what? You know, I'm here. I'm done. I've done my due diligence. I'm committed. Let's move forward as soon as possible. I'll balance out the debtor's needs for doing this, but not at the expense of giving everyone an equal opportunity. I want to be first, and I want to win this, or I wouldn't have been bidding." So you have a lot more leverage on the terms of the purchase agreement because it's your agreement that others are going to be commenting and competing off of, and orchestrating the timing related to the process.

Karen McC.: And in addition, George, one of the key benefits our clients have found, being the stocking horse bidder, is the ability to get a break fee if you're outbid in the process. And so, the stocking horse is the, what I like to think of as the lead purchaser, if you will, and sets the terms of the purchase, negotiates the sale order, has input into the process itself. And it places the bid that everybody else has to beat. And those incremental bids need to be in whatever the agreed-upon increments are, and they move up through the process. But, at the end of the day, if the stocking horse is the one that doesn't prevail in the auction, then they get a break fee, and the break fee typically more than adequately address the cost of participating in the transaction, so at least you remain whole at the end of the day for your effort.

George Singer: Or at least certainly close to whole. Usually you get the... The break fees I've seen are usually between 3 and 5%, depending upon the jurisdiction you're in and the nature of competition as you're doing things.

But Karen's exactly right. Having those fees, expense reimbursement, or breakup fees, mitigates all the expense that you've done in setting the floor for the auction. And also, it's an additional bidding increment. The next buyer that comes in has to both cover your purchase price, plus the breakup fee as their next starting bid. So it oftentimes makes people really put proof where their mouth is and have to come up with a larger increment to start the game.

Chad Stewart: All right. But I want to bring it back and talk a little bit, I guess, about COVID and what's different now in this economic downturn as compared to past economic downturns. Can we put this in some kind of historical context and say things are different now because?

George Singer: Well, [crosstalk].

Chad Stewart: And I'll throw that out there to both of you guys.

George Singer: ... I think that brings us back to where some of the comments I started initially with landlords and lenders. There has today been a lot more flexibility and patience on behalf of the lenders and landlords, understanding that if they push too hard, it may not be the best financial interest to do that because they're not... may not be an availability of a market for the assets if they foreclose. They may not realize as much at this time as they perceive that they'll realize if they ride it out.

It's the same thing with landlords. Finding other tenants in retail spaces, in particular, is it would be an extremely challenging thing to do in this environment and they understand that. So flexibility is one of the things that I'm seeing from both.

Karen McC.: And I'm also seeing a more willingness of investors and buyers, particularly financial buyers, to sort of wade into this process. In past downturns, you didn't see that as much, but people really are understanding that the circumstances that exist today are completely unique, and the concept of going in and saving a business, and keeping jobs, and helping people in that respect, is being viewed positively. So I'm seeing a willingness of financial buyers to participate more.

Chad Stewart: All right. Thank you.

Well, Karen and George, as we prepare to wrap up here, I have one more question for you, and that is what can buyers do to help position themselves to be the successful buyer of a distress company?

Karen McC.: Well, my thought first is you need to figure out how much you're willing to spend because, as both George and I have mentioned, I mean, the whole distress area by definition means that you're not going to have the same type of contractual protections that you can have outside of distress. So you need to spend money, be committed to spend money up front on your due diligence, on your process, on your understanding, because the entire integrity of the deal is going to rely on that. And so, you have to figure out upfront, "Am I willing to do this, and how much am I willing to spend?"

Bankruptcy is a very expensive process. It's very expensive from the bankrupt company side but it's also expensive from a participating bidder side. For all the reasons that George articulated, you could do a ton of work and not end up with the deal at the end of the day. So you really need to think about the cost, what you're trying to get out of the transaction, and figure that into the process.

And then, frankly, you need to engage experienced counsel and other experienced advisors too, who understand the distress world and can kind of bridge the gap between the M&A world and the bankruptcy lawyers, and to ensure a successful transaction for yourself.

George Singer: And I would say the... I echo Karen's comments wholeheartedly, and I would perhaps put an additional spin on it. It's a risk profile, right? Particularly outside of bankruptcy, and due diligence and doing all the things that Karen recommended helps mitigate that risk. You're not going to have someone to go after, after the deal is done. You're going to have angry creditors, perhaps a lot of people that aren't getting paid, they're looking for a way to get recourse and looking to the buyer, the new company, particularly if they're using the same name, they have the same employees. There's an additional element of risk and business acumen and professional advice and guidance that needs to happen and be thought through as you're approaching that process.

Chad Stewart: All right. Well, thank you both. I think this is a good place to wrap it up.

For our listeners who have questions about distressed or non-distressed M&A transactions, what is the best way for them to reach you? And Karen, I'll start with you.

Karen McC.: My email address is mcconnellk@ballardspahr.com. M-C-C-O-N-N-E-L-L-K. And my office number is (602) 798-5403.

George Singer: My email is singerg@ballardspahr.com. And mine is (612)371-2493.

Chad Stewart: All right. Well, thank you both for your time this afternoon.

John Wright: Thanks again, Chad Stewart, Karen McConnell, and George Singer.

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