# <u>ACQUISITIONS OF TROUBLED BUSINESSES: A COMPARISON OF THE BANKRUPTCY AND NON-BANKRUPTCY ALTERNATIVES</u>

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Acquisitions of troubled businesses pose both difficult problems and enticing opportunities. In almost every situation, financially troubled businesses are sorely in need of cash to meet operating expenses and apply to debt reduction. Anyone considering the acquisition of the stock or assets of a troubled business should consider whether the parties' goals could be better achieved in a bankruptcy or non-bankruptcy transaction. If approached properly, a sophisticated acquiror can purchase the troubled business or its assets at a bargain price while structuring the deal in such a way as to add new value to the target's lenders, unsecured creditors, employees and equity holders. If approached improperly, the acquisition of a troubled business or its assets may result in the assumption of unknown or unwanted liabilities as well as potentially debilitating litigation from the company's creditors, shareholders and others.

The first section of this article discusses the advantages of acquiring a troubled business through a consensual, out-of-court transaction. The second section discusses the advantages and disadvantages of the acquisition of a troubled business through use of Chapter 11 of the Bankruptcy Code.[2] The third section deals briefly with the acquisition of a troubled business through a pre-negotiated or prepackaged plan of reorganization.

## **The Non-Bankruptcy Alternative**

Many of the "advantages" of acquiring a troubled business outside of bankruptcy could more accurately be characterized as disadvantages of acquiring a troubled business in bankruptcy. It is, in fact, many of these disadvantages that make the non-bankruptcy alternative far quicker, less expensive and less complicated than the bankruptcy alternative.

[2] The Bankruptcy Code is codified at 11 U.S.C. §§ 101 et. seq.

*The Fishbowl Effect*. A company that files for bankruptcy is effectively required to operate in a fishbowl, disclosing to the world its assets, liabilities, creditors, customers, suppliers, revenues and other proprietary information.[3] Potentially most damaging is the fact that the debtor's officers and other key employees will be subject to examination on an almost at-will basis by any party in interest.[4] Moreover, this additional disclosure, as well as the stigma associated with bankruptcy, may cause an erosion of confidence of key constituencies including employees, vendors, lenders and the equity markets, as well as the perception of a fire sale which could cause the debtor's assets to fetch a significantly lower sales price than they might otherwise demand outside of bankruptcy.

*Cost and Time.* A bankruptcy acquisition will typically be more expensive and take more time than a non-bankruptcy acquisition. In bankruptcy, the debtor and other parties in interest are required to follow an elaborate set of rules and procedures which are not applicable outside of bankruptcy. For example, the debtor is required to obtain bankruptcy court approval for any action taken or transaction entered into outside the ordinary course of its business,[5] and give notice of these actions to its creditors.[6] As a result of these complicated rules and procedures, lawyers tend to play a larger role in bankruptcy transactions than they would outside of bankruptcy. Furthermore, in addition to the documentation that is required outside of bankruptcy, a bankruptcy sale requires either a motion and order if the sale is conducted outside a plan of

[3] See, e.g., Fed.R.Bankr. P.1007 (identifying lists, schedules and statements to be filed by the debtor).

[4] See Fed.R.Bankr.P.2004 (examinations) and 11 U.S.C. § 341 (first meeting of creditors).

[5] See, e.g., 11 U.S.C. § 363 (requiring bankruptcy court approval for certain actions) and Fed.R.Bankr.P. 9019 (requiring bankruptcy court approval of proposed compromises and settlements).

[6] See, e.g., Fed.R.Bankr. P.2002 (general notice requirements).

reorganization, or a plan and disclosure statement if the sale is consummated as part of a plan, thereby increasing the cost and further slowing down the process.

Another factor that tends to multiply the cost and time of a bankruptcy transaction is the increased number of parties which must be appeased. In a non-bankruptcy sale the seller can typically choose which parties to involve in the sale negotiations. These parties will generally include the company's lenders and other major secured creditors and, under certain circumstances, some of the company's largest vendors or customers. In contrast, bankruptcy tends to empower smaller creditors who, through their representation by a creditors' committee,[7] are likely to be given far more influence than they would otherwise have. Other constituencies such as equity security holders or employees may also be given the additional clout that comes from having their own committee. As a result of this additional leverage, as well as the involvement of attorneys at each stage of the process, there is an increased incentive for, and likelihood of, aggressive litigation. Worse yet, in bankruptcy, the debtor is generally responsible for paying the attorneys, accountants, investment bankers, and other professionals retained by any committees appointed in the case, as well as the fees incurred by its lenders. In an out-of-court sale, each party will typically bear its own costs with the possible exception of senior lenders who may be in a position to require the seller to pay its attorneys' fees in certain circumstances. These fees, however, will typically be far less than they would be in a bankruptcy sale.

[7] See generally 11 U.S.C. §§ 1102 (appointment of committees) and 1103 (powers and duties of committees).

*Appointment of Trustee.* Although rare, a court may appoint a Chapter 11 trustee to operate the debtor's business.[8] The appointment of a Chapter 11 trustee is not only a potentially expensive event, but may have a salutatory effect on the company's employees, lenders, major suppliers and customers, thereby decreasing significantly the value of the company's business or assets which it seeks to sell.

## The Bankruptcy Alternative

Depending on the circumstances, bankruptcy may be a more desirable or even necessary environment in which to sell a troubled business. Bankruptcy is particularly effective in holding off creditors who are seeking to be paid past due balances or foreclose on the debtor's assets, fostering negotiation between different creditor constituencies, permitting the debtor to avoid certain types of financial, contractual and other obligations and liquidating certain types of claims far more quickly and less expensively than could be accomplished outside of bankruptcy.

*The Automatic Stay.* One of the most important benefits of bankruptcy is the automatic stay, which is intended to give the debtor breathing room from its creditors.[9] The automatic stay prevents, among other things, the commencement or continuation of any lawsuit that was or could have been commenced before the filing of the bankruptcy petition, any act to collect a pre-bankruptcy debt, the enforcement against the debtor or property of the debtor's estate of a judgment obtained before commencement of the case, and any act to obtain possession of property of the estate, to exercise control over property of the estate, or to create, perfect or enforce any lien against property of the estate. Because the automatic stay prevents creditors from suing the debtor, seeking to

[8] See 11 U.S.C. § 1104 (appointment of trustee or examiner).

[9] The scope of the automatic stay is set forth in Section 362(a) of the Bankruptcy Code. Exceptions to the automatic stay are set forth in Section 362(b) of the Bankruptcy Code.

collect on past due balances and foreclosing on property of the debtor's estate, the automatic stay will give the debtor additional time to market the company, negotiate with creditors or consummate a sale.

*Ability To Obtain Financing.* Lenders and trade creditors may be unwilling to extend credit to a troubled business outside of bankruptcy for fear of being left with a large claim in a future bankruptcy. In bankruptcy, however, these same parties may be more willing to extend credit, content with the knowledge that the credit they extend after bankruptcy will be accorded priority of payment as an expense of administration in accordance with Sections 503(b) and 507(a) (1) of the Bankruptcy Code. To the extent necessary, after notice and a hearing, a debtor may also be able to give lenders "super-priority" claims with preference over all other expenses of administration,[10] or even grant liens with priority over existing liens.[11] Bankruptcy may, therefore, provide significant financing opportunities to a business that is no longer able to obtain trade or other credit outside of bankruptcy.

*Ability to Sell Assets Free and clear of Liens.* Another major advantage of acquiring a troubled business through a bankruptcy sale is that the Bankruptcy Code permits the sale of assets free and clear of all liens if the sales price is greater than the "aggregate value" of all liens on the property being sold. This may give the debtor the ability to transfer assets free and clear of liens when the dollar amount of liens is greater than the value of the assets being sold.[12] For example, in an asset sale outside of

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10 See 11 U.S.C. § 364(c).

11 See 11 U.S.C. § 364(d).

12 There is a split of authority on the meaning of "aggregate value" of a lien. Compare, e.g., In re Beker Indus. Corp., 63 B.R. 474, 476 (Bankr. S.D.N.Y. 1986) ("value" refers to the actual value of the lien, as determined by the court, rather than amount of lien) with In re Stroud Wholesale. Inc., 47 B.R. 999, 1001-02 (E.D.N.C. 1985) (sale price must exceed amount of debt secured by lien on collateral to be sold).

bankruptcy, absent an agreement to the contrary, the purchaser would take assets subject to the full amount of any liens secured by such property or, more typically, the full amount of the liens less the purchase price. The Bankruptcy Code, however, permits the sale of property free and clear of all liens provided that the liens attach to the sale proceeds, thus providing a significant advantage to a bankruptcy sale.

*The Stalking Horse Affect.* Any sale of the debtor's assets outside the ordinary course of the debtor's business must be approved by the bankruptcy court.[13] Because of the necessity for bankruptcy court approval, every acquisition agreement will necessarily be subject to higher and better offers at or before the sale hearing. This necessity for bankruptcy court approval gives the debtor the unique ability to continue shopping its assets after having entered into an acquisition agreement, effectively turning the purchaser into a stalking horse. Other interested parties are then able to bid for the assets at a sale hearing, thus permitting the debtor to maximize the sales price for the benefit of its creditors.

*Rejection of Burdensome Contracts and Leases.* A bankruptcy debtor has the right to reject executory contracts and unexpired leases to the extent that rejection would be in the best interest of the debtor's estate.[14] The rejection of a contract or lease constitutes a breach of such contract or lease immediately before the date of the filing of the petition.[15] Any claim for damages that the other party to the contract or lease may have against the debtor is, therefore, treated as a pre-bankruptcy claim to the extent the obligation is not otherwise secured. The ability to reject executory contracts and unexpired leases may be particularly valuable in situations in which the

[13] See 11 U.S.C. § 363(b).
[14] See 11 U.S.C. § 365(a).
[15] See 11 U.S.C. § 365(g).

debtor is party to above market contracts or leases, or the purchaser does not wish to be bound by certain contracts such as employment contracts, leases, supply contracts or almost any other type of contract that the debtor may have entered into prior to bankruptcy. The threat of rejection may also give the debtor or purchaser additional leverage to renegotiate the contract or lease.

*Lien Avoidance.* A bankruptcy debtor also has the right pursuant to Section 544 of the Bankruptcy Code to avoid certain transfers of property of the debtor, including unperfected liens and security interests in the debtor's property. Likewise, the debtor can avoid certain liens and security interests that were perfected in the 90 days before the commencement of the bankruptcy case (one year in the case of "insiders"),[16] to the extent those liens or security interests are not supported by a "contemporaneous" exchange of value.[17] Thus, for example, if a lender advanced funds on April 1 but failed to perfect its security interest until April 20, the debtor could likely avoid that security interest if it filed for bankruptcy on or before July 19, 90 days after the debtor's April 20 "transfer" of an interest in its property. The ability to avoid a lien or security interest could be particularly beneficial in an acquisition situation in which all or substantially all of the debtor's assets are encumbered by a lien or security interest in an amount greater than the value of the debtor's assets.

*Elimination of Unknown or Unmatured Claims*. As a general rule, the confirmation of a plan of reorganization discharges the debtor from any debt that arose before the date of confirmation. The term "debt" is defined to include any and all rights to payment, regardless of whether such right is liquidated, unliquidated, fixed,

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16 "Insiders" is defined at 11 U.S.C. § 101(31).
17 See generally 11 U.S.C. § 547(b).

contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.[18] A bankruptcy can, therefore, discharge the debtor from unknown, contingent or unmatured claims that a purchaser would be unwilling to assume. The bankruptcy discharge might be particularly important in a number of situations, including where the debtor's books and records are sufficiently unreliable to permit the purchaser to determine the extent of the debtor's liabilities. Although the courts are split on this issue, the bankruptcy discharge may also permit the purchaser to acquire the debtor's assets free and clear of "successor liability" claims such as product liability claims arising from goods manufactured prior to the date of bankruptcy, notwithstanding that the accident ultimately giving rise to the claim may not occur until well after the date of discharge.[19]

*Ability to Bind All Creditors.* Because a bankruptcy court order or a confirmed plan of reorganization will bind all of the debtor's creditors, regardless of whether those creditors vote to accept or reject a plan,[20] or object to an asset sale,[21] bankruptcy has a unique ability to foster negotiations between parties. A bankruptcy, or even the risk of a bankruptcy may, therefore, serve to increase the debtor's or purchaser's leverage in negotiating with the debtor's creditors, including its secured creditors. In addition to binding creditors, a bankruptcy court order approving the sale will, at a minimum,

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18 See 11 U.S.C. § 101(12) (defining debt) and 101(5) (defining claim).

19 See Epstein v. Official Committee of Piper Aircraft, 58 F.3d 1573, 1577 (11th Cir. 1995) (holding that "claim" exists against debtor-manufacturer only if "(i) events occurring before confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product"). But see In re White Motor Credit Corp., 75 B.R. 944 (Bankr. N.D. Ohio 1987) (court enjoined suit against successor company based on post-sale accident allegedly occurring as a result of pre-bankruptcy negligence in connection with manufacture of truck).

20 See 11 U.S.C. § 1141(a).

21 Section 363(m) of the Bankruptcy Code provides that absent a stay pending appeal, the reversal or modification on appeal of a sale order does not affect the validity of a sale to an entity that purchased property in good faith.

contain an implicit finding that the sale was fair, thereby minimizing the likelihood that the sale will be attacked later as a fraudulent transfer.[22]

*Flexibility of consideration.* The acquisition of a troubled business as part of a plan of reorganization may offer the purchaser the opportunity to be more creative in structuring the type of consideration offered than would be possible absent a bankruptcy. For example, the purchaser may be able to acquire at a discount secured or unsecured claims against the debtor's estate, which can then be tendered or waived as part or full consideration for the sale. The holder of a secured claim may also "bid in" the amount of the secured indebtedness in connection with an asset sold outside a plan of reorganization.[23] Under certain limited circumstances, the purchaser can also issue securities to the debtor's other creditors as part of a plan of reorganization, without necessity of registering those securities under the Securities Act of 1933.[24] Acquiring a troubled business as part of a plan of reorganization also makes it far easier than would otherwise be possible to reach an agreement under which all or part of the sales price is paid over time, either on a secured or unsecured basis.

*Exemption From Payment of Stamp Taxes.* Section 1146(c) of the Bankruptcy Code provides that "the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan . . . may not be taxed under any law imposing a stamp tax or similar tax." Thus, the transfer of securities as well as the recording of a real property deed or mortgage is not subject to a recording tax to the extent the transfer is provided for under a confirmed plan of reorganization. When a

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[22] Florida has adopted the Uniform Fraudulent Transfer Act which is codified in Chapter 726 of the Florida Statutes.

[23] See 11 U.S.C. § 363(k).

[24] See 11 U.S.C. § 1145.

sale includes the transfer of real property or the issuance or transfer of securities, a bankruptcy sale may thus reduce transaction costs.

*Ability to Liquidate Claims and Settle Lawsuits.* In many situations, bankruptcy can be used to expedite the liquidation of claims and the settlement of lawsuits against the debtor. This may be particularly useful in situations in which the debtor is a defendant in multiple pieces of litigation. The Bankruptcy Code also provides a procedure pursuant to which certain unliquidated or unmatured claims may be estimated.[25] To the extent these claims arose before the filing of the bankruptcy petition, they will then be treated as general unsecured claims against the debtor's estate.

*Tax Considerations.* A sale of assets as part of an out-of-court restructuring may be treated less favorably for federal income tax purposes than would the same transaction inside of bankruptcy. For example, a corporation must generally recognize as gross income for federal tax purposes, the amount of indebtedness that its creditors cancel in connection with a work out.[26] There is, however, an exception to this general rule to the extent that a company is insolvent or the indebtedness is canceled in connection with a bankruptcy case.[27] A solvent company would thus be required to recognize cancellation of indebtedness income if the restructuring were carried on outside of bankruptcy, but not if completed as part of a bankruptcy case. In either event, the debt cancellation will result in the reduction or elimination of net operating losses that the company could otherwise use to reduce future income. There may also be differences in the availability of net operating loss carryovers after a stock purchase,

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25 See, e.g., 11 U.S.C. § 502(c) (providing for the estimation of certain contingent or unliquidated claims).
26 See, e.g., U.S. v. Kirby Lumber Co., 284 U.S. 1 (1931).
27 See 26 U.S.C. § 108(a)(1)(A), (B).

depending on whether the acquired company was in bankruptcy at the time of the acquisition.[28]

## <u>Pre-Negotiated Bankruptcy Plans</u>

Pre-negotiated or pre-packaged bankruptcy plans offer many of the advantages of a bankruptcy transaction, together with the significant time and cost savings offered by an out-of-court sale. A company which is able to negotiate a sale with a purchaser and gain the approval of its major constituencies outside of bankruptcy can often file a bankruptcy petition, the required statements and schedules of assets and liabilities, and a plan of reorganization and disclosure statement on the same day. It is then possible to emerge from bankruptcy in as little as 45 to 75 days, depending on the speed with which the bankruptcy court is willing to usher the case through the bankruptcy process.

The pre-negotiated plan process is not only quicker than a traditional bankruptcy in which a plan and disclosure statement are not filed until several months after the bankruptcy petition is filed, but it may also be significantly less expensive. Because the debtor is in bankruptcy for only a short period, there is often little time for committees to form, opponents to gather supporters or mount a meaningful objection to a proposed plan of reorganization, or for lawyers to commence extensive litigation, as in a

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28 <u>See</u> 26 U.S.C. 5 382(1) (5).

traditional bankruptcy case. At the same time, a pre-packaged or pre-negotiated plan of reorganization offers many of the advantages of a traditional bankruptcy, including the automatic stay of all litigation, the ability to sell assets free and clear of liens, the ability to reject burdensome executory contracts and unexpired leases and to avoid liens, the elimination of unknown or unmatured claims, exemptions from the payment of stamp and similar taxes, exemptions from certain securities laws, the ability to be creative in the type of consideration offered to creditors, the tax advantages of a bankruptcy and the ability to bind all creditors to a confirmed plan of reorganization.

## **Conclusion**

Anyone contemplating the purchase or sale of the stock or assets of a troubled business should consider both the bankruptcy and non-bankruptcy alternatives. If properly structured, the parties may be able to add value without increasing the cost of the acquisition.