Using the Bankruptcy Code as an Acquisition Tool

By Andrew M. Apfelberg, Esq.

Rutter Hobbs & Davidoff Incorporated
1901 Avenue of the Stars
Suite 1700
Los Angeles, California (CA) 90067

310.789.1824 phone
310.286.1728 fax

aapfelberg@rutterhobbs.com
www.rutterhobbs.com

When you read in the paper about a bankruptcy filing, is it your perception that the company is failing or that it is taking an affirmative step to strengthen an ongoing business? Today, a number of companies intentionally file a Chapter 11 bankruptcy case as an acquisition tool or to facilitate a sale of the business or a significant portion of the company's assets. If your business, like those of such companies, would be largely unaffected by the disclosure of a bankruptcy proceeding, this could be just the break that your company has been looking for.

Real Life Example

An example of where the filing of a Chapter 11 bankruptcy case allowed for the sale of assets, where the deal was otherwise dead in the water, was the sale of Buzz Magazine to Los Angeles magazine. In that instance, the buyer was extremely concerned about unknown claims and wanted to make sure it was buying the assets free and clear. To alleviate this concern, the parties pre-negotiated the sale agreement and plan of reorganization and then filed a Chapter 11 bankruptcy case for Buzz Magazine. The bankruptcy petition and sale motion were filed on April 28 and the sale hearing was held and approved on May 20. The buyer paid $5.3 million for the magazine. Even including professional fees and other administrative expenses, the unsecured creditors were paid in full with interest, and funds were distributed to Buzz Magazine shareholders. Thus, utilizing the Bankruptcy Code allowed a deal to happen in lightning speed that would not have otherwise been possible.

Buyer's Perspective

From the Buyer's perspective, utilizing the bankruptcy process is advantageous because it can reduce the potential for successor liability and it allows for "cherry-picking" of the Seller's highest performing assets.

The Buyer's potential successor liability can be reduced through a sale approved by the Bankruptcy Court in three ways. First, separate and apart from the sale transaction, the Chapter 11 process provides a mechanism for creditors to make claims against the selling debtor-in-possession (through the filing of a proof of claim) and for the resolution and payment of such claims (through the claims objection process and the confirmation of a plan

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of reorganization). Second, oftentimes the parties will hold back a portion of the purchase price for a limited period of time in the event of a breach of the abbreviated representations and warranties found in the asset purchase agreement or for a discrepancy in the value of the assets on the date of closing. These two aspects function in a similar manner to a bulk sale escrow that is utilized for the sale of assets outside of a bankruptcy context.

The third way that successor liability can be limited, and one unique to the bankruptcy process, is through utilizing Section 363 of the Bankruptcy Code to sell assets free and clear of liens, charges, security interests, encumbrances and other interests in the property. If certain statutory circumstances are met, the bankruptcy court has the power to authorize the sale of property free of liens, with the liens attaching to the proceeds, without the consent of the lien holder. Other "interests" can include liabilities that do not operate as a lien. For example, Leckie Smokeless Coal Company was able to sell its assets free of successor liability that would otherwise have arisen under the Coal Industry Retiree Health Benefit Act of 1992.

Another advantage of utilizing the bankruptcy process to buy a company is that it allows for "cherry-picking" of the Seller's highest performing assets through the selective assumption and rejection of the selling debtor-in-possession's executory contracts. Section 365 of the Bankruptcy Code grants the debtor the power to reject its executory contracts. While there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due, to some extent, on both sides. Examples include leases of real property or equipment, supplier or distributor contracts, employment agreements and licenses of intellectual property. The rejection of a long term, over-market, non-residential real property lease can be particularly beneficial, as Section 502(b)(6) of the Bankruptcy Code caps the amount of damages from such rejection to the rent that otherwise would have come due under the lease for the greater of one year or fifteen percent (not to exceed three years) of the remaining term of the lease.

Seller's Perspective

From the Seller's perspective, the Bankruptcy Code provides tools that may permit it to assign a contract that otherwise would not be capable of transfer. It may supply a means of eliminating a contract or agreement that otherwise would be an impediment to the deal.

Under certain circumstances, Section 365 of the Bankruptcy Code grants the debtor the power to assume and assign its executory contracts to a third party. Many contracts can be assumed and then assigned to a third party, often over the objection of the party contracting with the debtor. This can occur even when the contract being assigned specifically includes a non-assignment provision or a provision stating that the filing of a bankruptcy case is an event of default. However, as a condition to the assignment, the debtor-in-possession will likely have to cure any arrearages and provide to the party with whom it had contracted adequate assurance of future performance.

The filing of a bankruptcy case can provide the debtor-in-possession a means by which to eliminate what would otherwise be an impediment to the consummation of a deal. For example, Continental Airlines filed a Chapter 11 bankruptcy case to gut a labor contract into which it had entered. A.H. Robbins filed a case to freeze approximately six thousand products liability claims brought by the insured users of the Dalkon Shield intrauterine device. Rock singer Tom Petty also filed a Chapter 11 case to get out of an unfavorable musical recording contract. Similar to the Buzz Magazine example, Souverain Winery used a Chapter 11 reorganization to restructure its debt and to sell its winery to Wine World, Inc.

The need for speed

A common misperception of the bankruptcy process is that it will extend the time within which a deal can be closed. As seen in the Buzz Magazine example, with careful advance planning, a deal can be done in slightly more time than if a Chapter 11 case had not been filed. The California Bulk Sale laws require a twelve-business day notice period to

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creditors. A motion to approve the sale of assets in the United States Bankruptcy Court for the Central District of California requires a twenty-four calendar day notice period--a difference of only six business or eight calendar days.

Moral of the Story

The moral of the story is not to be afraid of the Bankruptcy Code and not to assume a company is troubled just because it filed a bankruptcy case. Instead, with open-minded business people who can think "outside of the box" and attorneys who are cross-trained in acquisitions and insolvency, deals can get done and opportunities seized which otherwise would have passed by the wayside. Now that is the kind of newspaper article I would be interested in reading.

Andrew Apfelberg of Rutter Hobbs & Davidoff (www.rutterhobbs.com) was selected as a "Super Lawyer" in the Business Law practice area by the publishers of Law & Politics magazine (which was included in the February 2005 issue of Los Angeles magazine). "Super Lawyers" are the top five percent of attorneys in each state, as chosen by their peers and through independent research.

He serves as primary outside counsel to middle-market companies and entrepreneurs, advising on entity formation, finance, licensing of intellectual property, critical agreements with employees and third parties and mergers and acquisitions. Andrew can be reached at (310) 286-1700 or Aapfelberg@rutterhobbs.com.