Dealing with Financial Distress: Strategies for Acquiring Distressed Assets and Protecting Contractual Relationships

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Presentation Overview

• In the present economic environment all businesses will encounter entities with varying degrees of financial distress

• Those that understand the risks and applicable bankruptcy principles will be best prepared to minimize losses – this is particularly true as applied to contractual relationships

• Financial distress can also create substantial business opportunity
Focus of Presentation

- How does bankruptcy affect contractual relationships - - strategies to protect your interest when dealing with a distressed counterparty
- Acquiring distressed assets - - understanding the risks and the process of acquiring assets both before and within a bankruptcy case
Protecting Contractual Relationships in An Environment of Financial Distress
Bankruptcy Basics

• The automatic stay – impact on enforcement of contract rights.

• Rules Governing Executory Contracts and Unexpired Leases
  – What is an executory contract?
    • No statutory definition
    • Generally, any contract with material performance remaining by both parties is executory
  – What is an “Unexpired” lease?
  – Non-enforceability of “Ipso Facto” provisions
Assumption and Rejection

• Assumption: The process by which the debtor’s estate agrees to be bound by the contract or lease
  – Contract or lease must be assumed in its entirety
    • No cherry picking
    • Multiple documents as a single contract
    • Single document as multiple contracts
Assumption and Rejection (cont’d)

–Assumption Requirements:

• Governing standard is debtor’s business judgment

• Cure defaults
  • Monetary defaults
  • Non-monetary defaults

• Compensate for pecuniary loss resulting from defaults

• Provide adequate assurance of future performance

• Non-assumable contracts
Rejection

• Considered a prepetition breach – converts obligation to perform into dischargeable claim

• Rejecting a previously assumed executory contract or lease
  – Resulting claim for damages entitled to administrative priority
  – Statutory cap on administrative priority imposed by BAPCPA
Assignment of Executory Contracts and Unexpired Leases

- Bankruptcy Code overrides non-assignment clause
- The process of assumption and assignment
  - Who cures defaults?
  - Adequate assurance of future performance by assignee
- Non-assignable contracts
Timing for Debtor’s Assumption and Rejection

- Executory contracts generally
- Non-Residential real property leases
  - debtor as lessee
  - debtor as lessor
- Equipment leases
Performance Pending Assumption or Rejection

• Non-debtor may be required to perform continuing obligations

• Need to document debtor’s request for continuing performance
  – Right to administrative priority or other assurance of payment

• Limited ability to compel assumption or rejection prior to deadline
Protected Contracts Under the Code

• What is a “Protected” Contract – Forward Contracts

• Are you a “forward contract merchant” or “financial participant?”

• Benefits of Protected Contract Status
  – Termination based on bankruptcy filing
  – Ability to terminate, close out, net, and apply collateral
  – Protection from preference and constructive fraudulent transfer claims
Certain Energy Related Issues

• Treatment of Oil and Gas Leases
  – Unexpired lease or interest in land?
  – Rejection of oil and gas lease by debtor lessor
    • Lessee right to continuing possession

• Oil and gas purchase and/or supply agreements as protected contracts
Strategies for Protecting Contractual Rights

• Pre Bankruptcy Issues and Strategies
  – Ability to structure relationship as protected contract
  – Managing preference exposure
    • What is a preference?
    • Managing credit exposure to control preference exposure
      • New value defense to preference claims
    • Ordinary Course of business defense
Post Bankruptcy Issues and Strategies

- Identify and understand your contractual relationships and the rules governing them

- Take steps to ensure will be paid for pre-assumption/rejection performance
  - Do not volunteer performance; document debtor’s request for performance as necessary to benefit estate
  - Do not continue performing if debtor breaches post-bankruptcy
Post Bankruptcy Issues and Strategies (cont’d)

- Assess ability to compel early assumption or rejection

- Be prepared to document prepetition defaults and any pecuniary damage caused by such defaults
  - Protective proof of claim

- Monitor bankruptcy case and applicable assumption or rejection deadline
Acquiring Distressed Assets
Acquiring Assets Outside of Bankruptcy

- The Risk: Subsequent attack as fraudulent transfer
- The Buyers Conundrum: The lower the price, the greater the risk
Steps to reduce, but not eliminate, risk

- Financial Condition of Seller
  - No Safe Harbor
    - Can you get a solvency certificate?
    - Can you get a solvency representation?

- Fairness or “Reasonable Equivalence” of Purchase Price
  - No Safe Harbor
    - Requiring Seller to get a fairness opinion
    - Representations with regard to nature of sale process and resulting fairness of purchase price
    - Enhanced scrutiny and risk of related party transactions
Acquiring Assets From a Chapter 11 Debtor
Three Ways To Acquire Assets During A Pending Chapter 11 Bankruptcy Case

• acquiring assets sold in the ordinary course of the debtor’s business

• acquiring assets sold outside the ordinary course of the debtor’s business – the “363 Sale”

• Acquiring assets sold pursuant to a confirmed plan of reorganization
Sales Pursuant to Section 363 of the Bankruptcy Code

- Principal Advantages
  - Acquire assets “free and clear” of third party interests
  - Obtain assignment of executory contracts and leases without non-debtor consent
  - Eliminates fraudulent transfer risk
  - Ability of good faith purchaser to moot appeal of sale approval order
“Free and Clear” Sales Under The Bankruptcy Code

- Code allows sales of property “free and clear of any interest in such property”

- Right is not unlimited - One of following requirements must be met:
  - Applicable nonbankruptcy law permits sale of such property free and clear of such interest
  - The entity claiming the interest consents to the sale free and clear of its claimed interest
“Free and Clear” Requirements (cont’d)

- The claimed interest is a lien and the price to be obtained for the property exceeds the aggregate value of all liens asserted against the property

- The claimed interest is in bona fide dispute

- The entity claiming the interest can be compelled in a legal or equitable proceeding to accept a money satisfaction of such interest
Scope of Free and Clear Sale Order

• Common Misconception:
  – Code doesn’t authorize sales free and clear of claims
    • Liability imposed by law: The risk of successor liability
  – Most sale orders provide sales are “free and clear of liens, claims and encumbrances of any kind or nature: - - Why?
    • Sales Order Cannot Be Collaterally Attacked
Broad Notice is Critical: Final Sale Order is Binding on All Creditors That Received Notice of Sale

• Final order binding even if Court lacked power to enter order in first instance

• Buyer should require notice of sale be given to all known parties

• Consider publication if concerned about unknown creditors
To Be Successful – You Must Understand the Bankruptcy Sale Process

• Section 363 sales are subject to Court Approval

• Approval Standard: sound business judgment and in the best interest of the estate
  – Highest and Best Price Available
  – Assets Effectively Marketed
  – Competitive Bidding
The Stalking Horse Bidder

• Benefits:
  – Shape sales contract; potentially require other bidders to
    bid based on your form of contract
  – Ability to negotiate for and receive bid protection
    • Expense Reimbursement
    • Break-Up Fee
  – Careful! Break-up Fee Must Be Approved at Beginning of
    Sale Approval Process
Benefits (cont’d)

– Greater Control Over Bid Procedures and Bid Procedure Order

  • Key Elements:
    • Minimum over bid and bidding increments
    • Establish agreed deposit and related provisions
    • Establish stalking horse right to “Credit bid” break-up fee
    • Establish mechanism for valuing non-cash consideration
    • Establish whether piecemeal bids are permitted
    • Establish standard for valuing and comparing bids
    • Establish extent to whether debtor can bind losing bid as “back up” bid
Possible Disadvantages of Becoming Stalking Horse Bidder

- Risk of over-pricing assets
- Potentially allows other bidders to use stalking horse due diligence efforts
- Approve bid protection
The Sales Approval Process

• Two Step Process:
  - Step One: Motion To Approve Bid Procedures, including Stalking Horse Bid Protection
    • Establish bidding deadlines
    • Establish hearing dates
Step Two: Motion To Approve Sale

- Includes Proposed Sale Order
- Includes Process for Assumption and Assignment of Executory Contracts
- Time Table
Negotiating the Sale Approval Order

• Free and Clear language

• Factual Findings
  – Scope and propriety of notice
  – Fair value
  – Good faith purchaser status
  – Executory contract assumption and assignment procedures
  – Free and clear support
    • buyer not a successor
Negotiating the Purchase Agreement

- In most respects, a typical “corporate” transaction
- Provisions driven by bankruptcy or seller distress
  - Limited value of representations and warranties
    - Will debtor/seller survive?
    - Alternatives
  - Executory contract assumption/assignment provisions
    - Who pays cure amounts?
    - Commitments re provision of adequate assurance
Negotiating the Purchase Agreement (cont’d)

- Termination rights and relationship to bid protection payments
- Require buyer concurrence to form of sale order
- Right to compel closing in face of appeal to sale order

• Role of the Creditors’ Committee
Sales Under Chapter 11 Plans

- Potential Benefits:
  - May not require competitive bidding process
  - Transfer tax exemption
• Risks
  – Timing and lack of control
    • Plan process longer than 363 sale process
  – Focus of plan is on factors that often have nothing to do with proposed sale
  – Process delayed/derailed by matters unrelated to sale