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Opportunities for Lenders in Financing Bankruptcy Acquisitions

It seems clear that bankruptcy filings inevitably will increase in the near future, because of rising interest rates, pandemic-related micro-economic forces, global strife, and other macro-economic factors and their continuing strain on the global economy and individual businesses.

Consequently, strategic buyers and private equity sponsors should find expanding opportunities to purchase distressed businesses out of bankruptcy. Increased bankruptcy M&A activity also should provide attractive opportunities for lenders. In many situations, these transactions may be more attractive than non-bankruptcy financings, because the buyer should be able to assume only very specific and limited liabilities of the target. Although bankruptcy may add complexities and procedural issues, lenders generally should be able to minimize any associated risks by following the recommendations below.

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Bankruptcy Acquisition Process as It Relates to Financing

Bankruptcy Code §363(b)(1) provides that a debtor, "after notice and a hearing, may … sell, … other than in the ordinary course of business, property of the estate …" independent of a reorganization plan. The 363 sale process typically includes an interim hearing on bidding and sale procedures, an auction (if there are multiple bidders), and ultimately a sale approval hearing after notice of the proposed sale and an opportunity to object is provided to parties-in-interest.

As part of a bankruptcy sale, Bankruptcy Code §363(f) permits a debtor to sell its assets

free and clear of any interest in such property … if—(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Similarly, by virtue of a debtor's discretionary ability to assume or to reject executory contracts and leases, the buyer can select which contracts and leases it wishes to keep and which it prefers to leave behind. Using these and other tools afforded in bankruptcy, a buyer can often obtain the target business with significantly fewer

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legacy liabilities than in an acquisition outside of bankruptcy and limited open-ended exposure.

Although all bankruptcy sales are different, a debtor will typically try to enter into an agreement with a "stalking-horse" bidder to establish a minimum price, subject to higher or otherwise better bids, leading to an auction among competing bidders. If no stalking horse is available, the debtor will conduct an open sale process with the same goal of soliciting bids and conducting an auction. If there are multiple bidders, and an auction is held, the debtor and its advisors will determine the winning bidder, with input from key creditors, and the bankruptcy court ultimately will decide whether to approve the proposed sale.

In evaluating competing bids, the parties consider at least (1) the value of the consideration to be provided by the buyer, whether cash or in some other form, such as assumed liabilities; (2) any contingencies or uncertainties for the proposed sale that could impact the likelihood of closing; and (3) whether the buyer will be able to consummate the transaction in a timely fashion. Having committed financing is thus very important when trying to be chosen as the successful bidder.

Why Bankruptcy Acquisition Financing Opportunities Should Be Attractive to Lenders

Lender Protections. As a preliminary matter, lenders benefit from the protections a buyer receives in a bankruptcy sale. As a consequence of the buyer's purchasing the debtor's assets free and clear of most claims and liabilities, and determining which contracts will be maintained and which will be left behind, lenders should have a clearer picture of the target/borrower's go-forward operations. Those protections, in turn, provide lenders with a better understanding of their borrower's risk profile than what would be expected in a non-bankruptcy setting.

Specifically, there should be less risk of the buyer being subjected to unknown liabilities that exist in many operating businesses and that may lead to defaults and bankruptcy or otherwise put future lender recoveries at greater risk. In addition, the lenders' collateral is less likely to be subject to unexpected value leakage, because the collateral that was pledged when the sale was financed should not be subject to competing liens.

The Bankruptcy Court's Sale Order. The bankruptcy court presides over the sale and enters an order approving it, specifically providing for the buyer to obtain the debtor's assets free and clear of many pre-sale liabilities and obligations. The sale order typically contains protective provisions, such as:

- The purchased assets shall be transferred free and clear of any and all liens, claims, security

interests, and encumbrances, with all such interests attaching to the net proceeds of the sale;

- The order shall be effective as a determination that all liens, claims, security interests, and encumbrances against the purchased assets have been unconditionally released, discharged, and terminated and that the conveyance of the purchased assets has been effected and vested in the purchaser and is and shall be binding upon and govern the acts of all entities (including without limitation, all filing agents, filing officers, title agents, title companies, recorders of mortgages, recorders of deeds, registrars of deeds, registrars of patents, trademarks or other intellectual property, administrative agencies, governmental departments, secretaries of state, federal and local officials, and all other persons and entities that may be required by operation of law, the duties of their office, or contract, to accept, file, register, or otherwise record or release any documents or instruments or who may be required to report or insure any title or state of title in or to the purchased assets); and

• All persons and entities holding interests or claims of any kind or nature whatsoever against or in a seller, or the purchased assets, arising under or out of, in connection with, or in any way relating to the sellers/debtors, the purchased assets, the ownership/and or operation of the purchased assets prior to the date the sale is closed, are forever barred, estopped, and permanently enjoined from asserting any such interests or claims against the purchaser, its successors or assigns, its property, or the purchased assets.

By minimizing unknown exposures of purchasers/borrowers, the sale order also provides significant protection for lenders in the bankruptcy context, and lenders can rely on the sale order if any issues arise in the future with respect to competing claims against the lenders' collateral.

Additional Procedural Risks and Mitigation Measures

Although there may be some potential increased procedural complexities in the bankruptcy context, any associated risks can be addressed. Specific potential risks and mitigation strategies include:

Accelerated Process. The bankruptcy sale process is often accelerated and requires an expedited diligence process. Lenders and their professionals familiar with the bankruptcy sale process can protect against related risks by making sure they understand all material agreements and any assumed liabilities. Careful diligence of certain liabilities that could survive bankruptcy—such as environmental, tax, and product liability claims—is still necessary. However, the level of review should be less than regular M&A situations and more easily managed given that many liabilities can be isolated and left behind as part of the bankruptcy sale.

Lengthier Commitment. Depending on the sale process, the industry, and applicable government regulations, lenders may need to permit loan commitments to remain open longer than for non-bankruptcy deals. Indeed, the potential purchaser may become a "back-up" bidder that needs committed financing even if it does not initially win the auction. It is important for lenders in this context to be able to terminate their commitments upon some date certain, even if that date is further out than typical.

Greater Flexibility. During the sale process, the purchaser also may require some flexibility in the form of additional financing from the lenders to provide "dry powder" to allow the purchaser to make multiple bids prior to or at an auction. In this context, lenders will need to be more accommodating and nimble with additional availability than outside of bankruptcy. Similarly, lenders may need to be prepared to fund the entire loan at closing and then complete any syndication later.

Sale Order Terms. Lenders should make sure that they and their counsel have input into the language of the sale order and include in any commitment letter or similar agreement consent rights over the substance of the sale order. Indeed, lenders should not be required to lend if there are any changes to the business deal that could alter the purchaser's capital structure or risk profile in a manner that would not be acceptable to the lenders.

Conclusion

Lenders should have increased opportunities to finance bankruptcy sales in the near term. Lenders should view these opportunities as being at least as advantageous as financing non-bankruptcy acquisitions, in part given that the scope of liabilities that the purchaser will assume should be more circumscribed. Although the bankruptcy process introduces some procedural complications, retaining experienced professionals and following some of the recommendations detailed above can help lenders handle those complications and mitigate any associated risks.

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