ACQUIRING A TROUBLED BUSINESS
in Bankruptcy or Outside of Bankruptcy

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I. GENERAL METHODS BY WHICH TO PURCHASE AN INSOLVENT BUSINESS OR ITS ASSETS

A. Purchase of Assets in Bankruptcy Without Any Plan of Reorganization ("Plan").

B. Purchase of Assets in Bankruptcy Through a Plan Negotiated Post-Bankruptcy Filing.

C. Purchase of Assets in Bankruptcy Through a Pre-Packaged Plan.

D. Non-Bankruptcy Purchase of Business or Assets. (i.e. Merger; Stock Purchase)

E. Purchase of Assets or Control Position in Bankruptcy Through Purchase of Claims Against Debtor.[1]

II. GENERAL CONSIDERATIONS IN PURCHASING AN INSOLVENT BUSINESS INSIDE OR OUTSIDE OF BANKRUPTCY

A. **Ability to Bind Non-Consenting Creditors**. A primary consideration in purchasing an insolvent business outside of bankruptcy is that the purchaser will be unable to bind dissatisfied creditors of the purchaser who do not expressly consent to the sale transaction.

B. **Fiduciary Duties of Directors and Officers**. Directors and Officers ("D&O's") of an insolvent company have fiduciary duties not only to shareholders but to all creditors. In fact, the more insolvent a corporation becomes, the more these duties shift entirely to creditors. Accordingly, D&O's goal cannot be limited to maximization of shareholder value, but must also maximize the return to creditors.

C. **Fiduciary Duties of Management**. The management of a Debtor also has a fiduciary duty imposed under bankruptcy law to obtain the highest and best price on any sale of assets.

D. **Auction of Company**. Outside of bankruptcy, D&O's have a duty to conduct an auction whenever a corporation's actions make the dissolution or break-up of the corporate entity inevitable. It is likely this duty also exists to some extent in bankruptcy cases.

1. In addition, private sales generally are disfavored in the bankruptcy context. Rather, an auction of assets is usually required. As described below, a Plan may be of use in avoiding an auction.

[1] The term "Debtor", means a business in bankruptcy.

2. The procedures at the auction are quite important. The initial offeror (the "stalking horse") must consider obtaining bidding protection necessary to ensure that competitive bidders are not "free riders" on the stalking horse's due diligence and valuation of the Debtor's business. Various procedural mechanisms used at bankruptcy auctions are discussed below.

E. **Debtor's Agreements Require Court Approval in Bankruptcy**. In bankruptcy cases, no agreement outside of the ordinary course of the Debtor's business is binding upon the Debtor until approved by the Bankruptcy Court.

1. Because the vast majority of significant asset sales are inherently outside the ordinary course of business, these sales generally require court approval and are subject to third party objections. An objector and the Debtor may also be entitled to discovery to develop facts in support of their respective positions.

2. A purchaser can be bound by its execution of a letter of intent or purchase agreement to purchase a Debtor's assets, even if the Debtor is not bound.

F. **Asset Sales in Bankruptcy Generally are Free and Clear of Liens and Claims**. The major benefit provided by a Bankruptcy Court order approving an asset sale or sale under a Plan is that the Debtors' assets are transferred to the purchaser free and clear of virtually all liens and claims.

1. Some dispute exists as to whether the Bankruptcy Court can effectively order the transfer of assets free of successor liability for certain product liability and environmental claims, e.g., future claims such as unmanifested asbestos claims or anticipated but contingent product liability claims. In addition, certain environmental laws impose current owner/operator liability on a purchaser regardless of the identity of previous owners of the assets.

2. Bulk Sales law does not apply in bankruptcy.

3. Representations, warranties and indemnifications may be of little value when buying an insolvent entity.

G. **Constituencies**. Numerous constituencies must be dealt with in purchasing the assets of an insolvent entity. Such a purchase is not simply a two party transaction between a seller and buyer. A purchaser may have to negotiate with or address the concerns of:

1. trade creditors;

2. bondholders;

3. tort claimants;

4. an unsecured creditors' committee;

5. a shareholders committee;

6. lessors;

7. secured creditors;

8. employees;

9. governmental entities;

10. the United States Trustee; and

11. the Bankruptcy Court.

III. 363 SALES - PURCHASE OF ASSETS IN BANKRUPTCY WITHOUT ANY PLAN OF REORGANIZATION

A. **Section 363 of the Bankruptcy Code**. A sale of assets in bankruptcy without a Plan is accomplished pursuant to Section 363(b) of the Bankruptcy Code ("363 Sale"). Section 363(b) provided that "… after notice and a hearing, [a Debtor] may use, sell or lease, other than in the ordinary course of business, property of the estate." If no entity objects to the proposed sale, the Bankruptcy Court may approve the sale without a hearing.

B. **Flexible Process**. The 363 Sale process is extremely flexible.

1. All required time periods relating to the sale are subject to change by the Bankruptcy Court.

2. In particular, the Bankruptcy Court can modify procedures and time limits for

a. bidding;

b. auctions;

c. notice to interested parties;

d. advertising; and

e. all other procedures concerning the sale process.

C. **Tension Between 363 Sale and Plan**. There is often a tension between a Debtor's desire to sell assets pursuant to a 363 Sale and the provisions of the Bankruptcy Code dealing with Plan proposal and confirmation.

1. The Bankruptcy Code does not expressly prohibit a Debtor from selling all or substantially all of its assets pursuant to a 363 Sale.

2. When a Debtor seeks to sell substantially all of its assets pursuant to a 363 Sale, a common objection is that, by doing so, the Debtor is short-circuiting the more elaborate safeguards of the Plan confirmation process, especially the duty to provide adequate information to parties in interest.

D. **Standards for approving a sale of substantially all of a Debtor's assets without a Plan**.

1. **Emergency Rule**. Some courts have adopted the position that a court can approve such a sale only if the value of the assets is declining or if the assets are of a perishable nature, i.e., an emergency exists.

2. **Good Cause Rule**. Other cases have rejected the "emergency" rule and held that a sale of substantially all the assets of a Debtor can be approved without a Plan for "good cause."

3. **Majority Rule**. The majority rule now is that no emergency is required, so long as several of the following factors are present:

   a. The assets have been properly advertised and marketed and a vigorous bidding process ensued.

   b. The sale has not been arranged for the benefit of the Debtor and/or the Debtor's management.

   c. Pre-petition shareholders do not have an interest in the purchasing entity.

   d. The effect of the proposed sale does not constrict the Debtor's ability to confirm a Plan.

E. **Section 363 Sale Timing**. A typical time line for accomplishing a purchase through a 363 Sale is as follows:

1. **1 - 60 days**. The purchaser completes due diligence. (Environmental due diligence may require more than 60 days if more than a Phase I environmental audit is necessary.)

2. **3 - 21 days**. The Purchaser and the Debtor negotiate a letter of intent.

3. **5 - 30 days**. Before submitting the proposed sale to the Bankruptcy Court, the purchaser should attempt to obtain approval from and support of necessary constituencies for 363 Sale. It may not be necessary to obtain the consent of all constituencies, depending upon their economic interest. However, a transaction in the Bankruptcy Court will be approved much more expeditiously if it is a consensual transaction than if it is a contested transaction.

4. **4 - 20 days**. A 363 Sale motion is filed with the Bankruptcy Court for approval of the transaction including approval of bidding procedures and break-up fees. The Bankruptcy Court approval generally takes place in two stages, as described below.

5. **20 - 45 days**.

   a. Notice provided to all creditors and potential competing bidders through direct notice and/or advertisement in newspapers.

   b. A final hearing is held to approve the transaction.

6. **0 - 20 days**. The transaction is closed.

7. Many of the time periods set forth above may run concurrently. The actual time period can be as short as 7 days.

F. **Bankruptcy Court Approval of a 363 Sale Takes Place in Two Stages**

1. **First Stage**. The first stage entails the Debtor obtaining Bankruptcy Court approval of the bidding protection procedures. These procedures are described in a motion filed with the Bankruptcy Court seeking Bankruptcy Court approval of the procedures. This motion can be heard on an expedited basis. Examples of the bidding protection procedures sought by purchasers include:

   a. **Solicitation Procedures**. The establishment of procedures that limit the Debtor's solicitation of competing bids, such as:

      i) Prohibiting the Debtor from directly or indirectly soliciting further offers for the assets. (However, it is unlikely that the Bankruptcy Court would preclude the Debtor from providing information to prospective competing bidders in response to unsolicited inquiries.)

      ii) Requiring potential competing bidders to submit competing bids at least 1 - 7 days before the final hearing on approval of the purchase agreement.

      iii) Requiring the terms and conditions of the competing bid to be the same as, or substantially similar to, those contained in the purchaser's purchase agreement.

   b. **Auction Procedures**. The establishment of auction procedures that could include:

      i) The holding of an auction in the event qualified competing bids are submitted prior to the final hearing on the sale.

      ii) A requirement that all bids be in minimum incremental amounts.

      iii) A requirement that the initial topping bid exceed the current bid by a certain percentage or dollar amount.

      iv) A provision allowing the purchaser the right to match any qualifying bid.

      v) The provision of a break-up or topping fee to the purchaser. The break-up fee can take the form of:

         a) Full or partial expense reimbursement.

         b) A percent of the increased amount of the bidding.

         c) A set fee.

d) A combination of the above.

e) A provision requiring bids to be judged on the basis of which bid provides the most net cash to the Debtor. (In the event a break-up fee, topping fee, or expense reimbursement is promised to a purchaser, the bid then would be judged on the basis of the highest net dollars to the estate rather than the gross cash amount of the bid, thereby requiring a competing bidder to bid more throughout the bidding process to provide the same net return to the estate.)

f) Some courts, after bidding has proceeded, require the submission of a sealed highest and last best bid.

g) In a broad sense, another strategic "bid protection" device may be employed by the purchaser in the form of debtor-in-possession financing. To the extent the Debtor is in sufficiently dire need of such financing and, to the extent the purchaser is the only available financing source, the purchaser can link the financing to the approval of satisfactory bid terms and auction procedures.

2. **Second Stage**. The second stage is the hearing on the sale of the assets itself. On the date of the hearing the auction ordinarily occurs, followed by the Bankruptcy Court's consideration of any objections to the 363 Sale.

3. **Variations On The Two Stage Procedure**.

a. **No First Stage**. In some § 363 sales, no first stage court hearing ever occurs, i.e., no bidding, auction or expense reimbursement procedures are established until the auction occurs immediately prior to the hearing to approve the sale. In this case, Purchaser will have little procedural protection.

b. **No Letter of Intent**. In some § 363 sales, no letter of intent is executed. Rather, Debtor or Debtor's investment banker solicits sealed bids for Debtor's assets and negotiates a contract with the winning bidder.

4. **Standards For Approving 363 Sale**. The standard that the Bankruptcy Courts generally apply is whether a sound business reason supports the sale. The following factors are ones that a Bankruptcy Court can apply in determining whether the sale is supported by sound business judgment reasons:

a. The proportionate value of the assets to the estate as a whole.

b. The amount of time elapsed since the filing.

c. The likelihood that a plan will be proposed and confirmed in the near future.

d. The effect of the proposed distribution on future plans of reorganization.

e. The proceeds to be obtained from the disposition compared to appraisals of the assets.

f. Whether the asset is increasing or decreasing in value.

5. The following factors need to be satisfied in addition to showing that the sale is supported by sound business judgment reasons.

a. Interested parties are provided with adequate and reasonable notice.

b. The sale price is fair and reasonable.

c. The purchaser is acting in good faith. A purchaser should obtain a finding from the Bankruptcy Court that it is a good faith purchaser under section 363(m) of the Bankruptcy Code.

G. Activities That Take Place Between the First and Second Stage

1. **Purchase Agreement Completed**. Purchaser and Debtor complete negotiation of the definitive purchase agreement. A purchase agreement in the 363 Sale context differs markedly from the non-bankruptcy purchase agreement.

a. Because the Debtor typically is insolvent, the purchaser cannot expect to derive any significant protection by means of Debtor's representations, warranties and indemnification.

b. Hold-backs and escrows typically are more difficult to negotiate because creditors generally demand a known net purchase price.

c. Absent Bankruptcy Court approval, a Debtor will not be bound by any agreement executed outside the ordinary course of business, including a 363 Sale purchase agreement. However, absent an express provision to the contrary, the purchaser may, in fact, be bound at the time of execution.

d. The agreement should include deadlines for the Debtor's presentation of motions to approve the bid and auction procedures, and for approval of the sale itself, as well as deadlines for the entry of orders approving these motions.

e. Provisions concerning location of litigation relating to the purchase generally will not be effective to prevent the Bankruptcy Court from continuing to exercise jurisdiction over many aspects of the transaction.

f. Provisions concerning expense reimbursement or break-up fees must be drafted to address priority of claim issues, e.g., whether payment of the purchaser's expense reimbursement or break-up fee will "prime" the senior secured lender.

g. Effectiveness of the purchase agreement must be conditioned on the entry of an order approving the sale which is satisfactory to purchaser.

h. The purchase agreement should contain a method for the Debtor's assumption and assignment to Purchaser of contracts in order to ensure that all defaults are cured.

2. **Due Diligence**. Purchaser will complete its due diligence examination of Debtor.

3. **Financing**. Purchaser will obtain financing for the transaction.

4. **Antitrust**. Purchaser will obtain any necessary regulatory approval (including Hart-Scott-Rodino antitrust clearance). The Bankruptcy Code shortens the normal 30 day review period to 10 days.

H. **Competing Bidders Generally Have No Standing**. Although the issue is somewhat unsettled, competing bidders generally do not have standing before the Bankruptcy Court to object to the procedures for a 363 Sale. The rationale is that competing bidders are strangers and volunteers to the proceedings. The real parties in interest, the creditors and the Debtor, have standing to establish or dispute the procedures. Generally, the competing bidder's remedy is not to bid if it is unsatisfied wit the procedures.

1. Thus, the initial purchaser can negotiate the procedures with the Debtor and the creditors and it is unlikely a competing bidder can successfully object to them.

2. However, a Bankruptcy Court can alter any procedures it establishes. The court ordinarily will not focus on fairness to a competing bidder or purchaser, but on what procedures will produce the best return to the Debtor. It is unlikely a bankruptcy court would overturn procedures supported by the Debtor and major creditors even where competitive bidders feel aggrieved in the auction process.

3. The Bankruptcy Code provides that any creditor is a "party in interest" with the right to be heard on any issue in the bankruptcy proceedings. Therefore, a competitive bidder may be able to obtain standing to object to unfair auction procedures by buying a small claim against the Debtor.

I. **Judicial Involvement**. There is no specific prohibition against a bankruptcy court conducting, or being present for, the auction.

1. **Judicial Non-Participation**. Some bankruptcy judges believe they should not be involved in auctions and allow the Debtor to conduct the auction outside the presence of the judge. These judges believe that they should limit their involvement in the case to ruling on legal disputes, as opposed to becoming involved in the actual administration or operation of the Debtors' estate.

a. Even when the judge is not present at or involved in the auction, he/she generally remains available to rule on any disputes concerning the propriety of bidding and auction procedures.

b. These judges also often take the position that the Debtor has discretion in the reasonable exercise of its business judgment, to set the auction procedures, and

even to modify the same during the auction process, in order to obtain the highest and best recovery for the Debtor.

2. **Judicial Participation**. Some bankruptcy judges do participate and conduct auctions. Those judges are much more involved in setting the auction procedures.

J. **A Purchaser in a 363 Sale Takes the Assets Free and Clear of Liens and Encumbrances**

1. **Standards must be met**: One benefit of purchasing assets in a 363 Sale is that a purchaser takes the assets free and clear of liens and encumbrances. Section 363(f) of the Bankruptcy Code provides that assets may be sold free and clear of the liens, claims, encumbrances and interests of third-parties without their consent only if one of five conditions is met:

a. Non-bankruptcy law permits a sale of the assets free and clear of such interest;

b. The interest holder consents;

i) When consent is not available, it is not unusual that a bona fide dispute exists with respect to the lien.

ii) Apart from other objections to a 363 Sale, if the purchase price for the assets is the best obtainable under the circumstances, many bankruptcy courts will approve a sale over a lienholder's objection, even where there is no bona fide dispute with respect to the lien and the sales price is less than the face amount of the secured debt.

c. The interest is a lien and the price for the assets is greater than the aggregate value of all liens on such property;

d. The interest is in a bona fide dispute; or

e. The holder of the interest could be compelled to accept a money satisfaction in a legal or equitable proceeding.

K. **Limitations on Avoidance of Liabilities**. Courts differ as to whether a purchaser can take Debtor's assets free and clear of certain potential liabilities which do not arise until after the sale, for example:

1. **Product Liability**. A product sold by the Debtor before the purchase causes an injury after the purchaser buys Debtor's assets;

2. **Asbestos**. A person who was exposed to Debtor's asbestos products before the purchase manifests disease after the purchase; or

3. **Environmental**. An oil leak which occurred before the purchase results in a cleanup order after the purchase.

L. **Environmental - Owner/Operator Liability**. Federal law probably also imposes on a purchaser the primary environmental cleanup obligation for pollution previously caused by or existing on the assets purchaser purchased from Debtor, because purchaser has become the new owner/operator of those assets.

M. **Bulk Sales Act Inapplicable**. The Bulk Sales Act does not apply to a 363 Sale. Hence, except for Debtor's potential liabilities which do not arise until after the sale to purchaser and environmental cleanup obligations, the 363 Sale prevents the purchaser from becoming liable for Debtor's other liabilities.

N. **Transfer Taxes Not Avoided**. Normal state transfer and income taxes ordinarily apply to a 363 Sale. If a bankruptcy case is filed in Delaware, however, the Debtor can request that the sale be exempt from transfer taxes under section 1146(c) of the Bankruptcy Code.

O. **Stock Purchase**. Ordinarily, a 363 Sale purchaser will not purchase the stock of a Debtor.

1. The purchase of stock will subject the purchaser to all the liabilities of the Debtor.

2. If a purchase of stock is necessary to take advantage of a tax benefit, it is likely the purchase would occur through a Plan. As described below, a Plan allows for more flexible structuring alternatives than does a 363 Sale.

3. If the Debtor is a holding company, or a conglomerate with various subsidiaries that are not in bankruptcy proceedings themselves, it is more likely that the Debtors' stock in a subsidiary will be the subject of a 363 Sale.

P. **The Debtor's Contracts** In a 363 Sale, the purchaser can determine which of the Debtor's contracts it wants to assume.

1. **Assumption/Assignment Opportunities**. Section 365 of the Bankruptcy Code allows purchaser to assume most leases and contracts without any liability for defaults that occurred prior to the assignment to purchaser. To take over contracts and leases, however, defaults must be cured (often out of the purchase price) and the purchaser must be prepared to provide "adequate assurance of future performance" under the contracts or leases. Generally, a -purchaser will meet this test if it is in the same or better financial condition as the Debtor was at the time the Debtor executed the contract or lease.

2. **Rejection of Leases/Contracts**. Alternatively, a purchaser can purchase Debtor's assets free of those Debtor leases and contracts that the purchaser does not desire to acquire.

Q. **Finality**

1. It is very difficult for any objecting party to overturn on appeal an order approving a 363 Sale.

a. **General Rule**. Under the Bankruptcy Code, the beneficiary of an order generally cannot act upon that order for ten days.

b. **363 Sales May Close Immediately**. However, a purchaser may close a transaction immediately upon the entry of an order approving a 363 Sale.

c. **No Unwinding of Sale**. Section 363(m) of the Bankruptcy Code provides that a purchaser who purchases assets in good faith cannot have a transaction unwound on appeal even if the appellant obtains a reversal of the order approving the 363 Sale. Thus, a purchaser should obtain a finding from the Bankruptcy Court that it is a good faith purchaser.

i) Thus, in the event (i) an appeal is filed, and (ii) the appellant does not obtain a stay of the 363 Sale approval order, and (iii) the sale closes, a substantial body of case law holds that the appeal should be dismissed as moot because the appellate court cannot unwind the transaction, and it would be a waste of appellate court resources to consider an appeal on which no relief can be granted.

ii) Accordingly, the only practical method by which a 363 Sale can be stopped after it is approved by a Bankruptcy Court is for the aggrieved party to obtain a stay of the 363 Sale approval order from an appropriate court. It is unlikely that a stay can be obtained without the posting of a bond. The Bankruptcy Court has discretion in setting the bond amount. However, the bond amount should be in an amount at least equal to the purchase price.

R. **Issues That May Arise**

1. **A Debtor Has Strong Influence Over Which Bid to Accept.** A Debtor has tremendous discretion whether to recommend a purchaser's bid to the Bankruptcy Court.

a. It is very difficult for a purchaser to force a recalcitrant Debtor to sell its assets.

b. It is difficult for the Creditors' Committee to force the sale of assets when the Debtor does not want to sell its assets and the Debtor remains in control.

c. If a Creditors' Committee desires that a Debtor sell its assets and the Debtor refuses, the usual alternative is to attempt to remove the Debtor from control to force the sale. A less drastic measure would be for the Committee to seek an end to the Debtors "exclusive" right to file a Plan and, if successful, to then attempt to confirm a creditors' Plan implementing the sale.

S. **Collusive Bidding Prohibited**. Parties can enter into a joint venture to purchase assets out of bankruptcy. However, while pooling of resources for bidding purposes is often a legitimate business tool, purchasers must be particularly careful in the bankruptcy context to avoid being accused of collusive bidding, i.e. "controlling the sale price by an agreement among potential bidders." Bankruptcy Code § 363(n) allows for compensatory and even punitive damages if collusive bidding is found.

1. **Joint Venturing**. Unfortunately, a combination of two or more potential bidders often makes the most logical vehicle for a purchase. To avoid collusive bidding liability, early

disclosure of joint bidding intentions before formally entering the bidding process sometimes is advisable. How and when would depend on the particular circumstances.

IV. PURCHASE OF ASSETS IN BANKRUPTCY THROUGH A NEGOTIATED PLAN

A. **Plan of Reorganization**. A Plan of Reorganization is the culmination of the Chapter 11 process. It provides the method by which all of the Debtor's assets will be in administered and/or distributed, and its liabilities will be satisfied. A Plan may provide for the sale of all or any part of the property of the estate. The Plan often is consensual. However, as described below, non-consensual plans may be approved by the Bankruptcy Court in certain instances.

B. **Requirements of Bankruptcy Code**. Plans, including liquidating plans, are subject to numerous requirements set out in Chapter 11 of the Bankruptcy Code. The major requirements for confirmation are:

1. The Plan complies with all of the provisions of the Bankruptcy Code.

2. The proponent of the Plan has complied with all of the provisions of the Bankruptcy Code.

3. The Plan is proposed in good faith and not by any means forbidden by law.

4. The Plan discloses all payments to be made under the Plan.

5. The proponent of the Plan must disclose the identity and affiliations of all individuals proposed to serve as D&O's of the reorganized Debtor and the nature and amount of compensation to be paid to such D&O's.

6. All regulatory approvals have been obtained.

7. The Plan is in the best interests of creditors. Best interests means the Plan provides a greater return to each individual creditor than such creditors would receive if the Debtor was liquidated pursuant to a chapter 7 liquidation case.

8. Each class has accepted the Plan. The level of acceptance required for a class of claims to accept a Plan is one-half in number of claimants and at least two-thirds in dollar amount of claims. The level of acceptance required for a class of equity interests is at least two-thirds of the class, by number of shares.

9. Priority claims generally must be paid in full when the Plan becomes effective, unless otherwise agreed to by the priority claimant.

10. The Plan is feasible. Feasibility essentially means that the confirmation of the Plan is not likely to be followed by the need for further reorganization or liquidation of the Debtor.

11. All present retiree benefits programs must be continued, unless altered through a rigorous procedure.

C. **Disclosure Statement**. The Plan must be fully described in a written disclosure statement supplied to creditors and other parties in interest.

D. **Disclosure Statement Hearing**. A hearing must be held upon notice to creditors and parties in interest to determine the adequacy of the information contained in the disclosure statement. Generally, the disclosure statement must contain information reasonably sufficient to enable each creditor or equity holder as a "hypothetical reasonable investor" to make an informed judgment as to whether to vote to accept or reject the Plan.

E. **Solicitation of Votes**. Votes on the Plan must be solicited from holders of claims against or interests in the Debtor.

1. Securities in a reorganized Debtor or its successor that are offered or sold under a Plan in many circumstances are exempt from the Section 5 registration requirements of the federal securities laws. (Section 1145 of the Bankruptcy Code).

2. Section 1125(e) of the Bankruptcy Code provides a safe harbor from liability for violation of the anti-fraud provisions of federal and state securities laws if votes on a Plan are solicited in good faith and in compliance with applicable provisions of the Bankruptcy Code. The safe harbor does not relieve a Plan proponent from complying with the disclosure requirements of such laws.

F. **Confirmation Hearing**. A hearing on confirmation of the Plan must be held to determine whether all requirements for confirmation have been met.

G. **Cram-Down**. In instances where all classes do not accept the Plan, the Plan proponent may attempt a "cram-down" of the Plan on non-accepting impaired classes of creditors and equityholders. To "cram-down" a plan on unsecured creditors and shareholders, a Debtor:

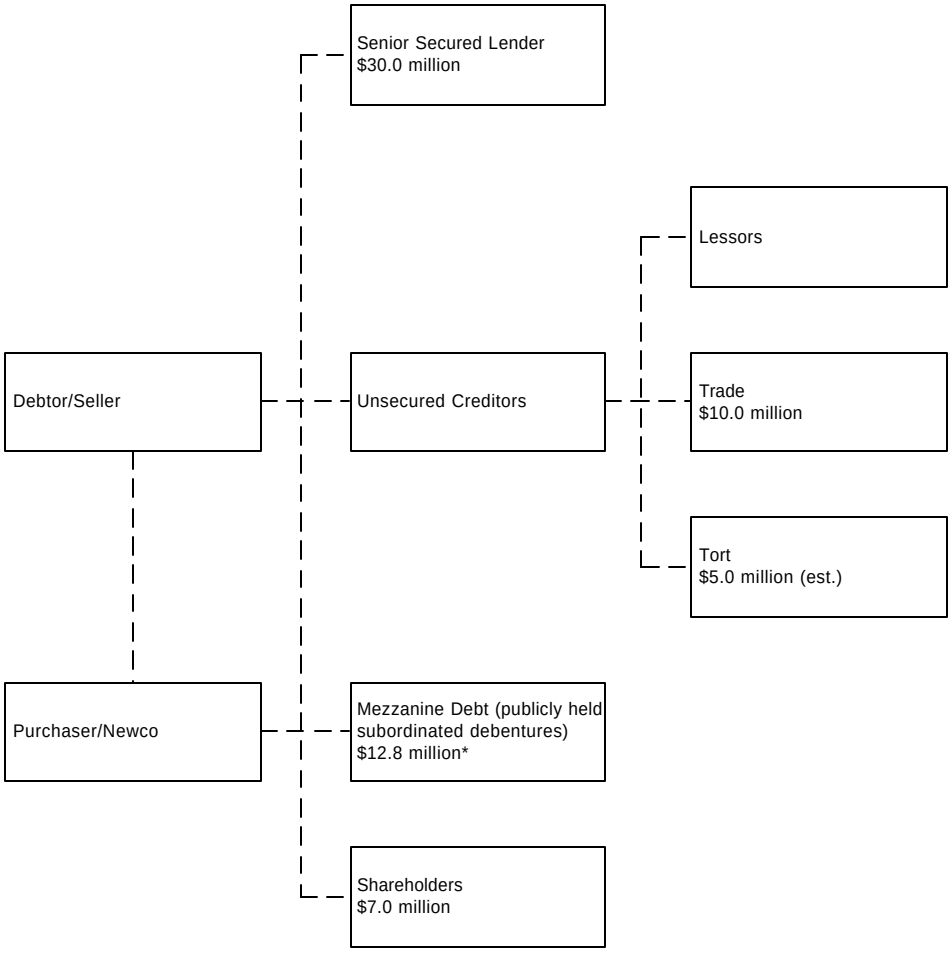
1. must obtain the acceptance of at least one non-insider impaired class (a class is impaired if the Plan alters the legal, equitable or contractual rights of any claim or interest holder in the class); and

2. must satisfy the absolute priority rule. The absolute priority rule requires that no junior class may receive or retain any consideration under a Plan until all classes senior to that class have been paid 100% of their claims.

   Where a current shareholder contributes new money or property in connection with a Plan, a "new value exception" to the absolute priority rule may allow the shareholder to retain shares in the reorganized company equal to the value of the new contribution. However, the law is unsettled as to whether this exception even exists.

H. **Greater Flexibility Under Plan**. Despite the stringent confirmation process requirements, purchasing assets through a Plan allows a purchaser far more flexibility than the purchase of assets through a 363 Sale.

I. **Sample Transaction**: To illustrate the flexibility in structuring a purchase through a Plan, consider a Debtor with the following capital structure:



*Subordinated to Senior Secured Lender and Trade Debt

1. Based on the fact pattern set forth above, a purchaser through a Plan could structure the following transaction:

    a. Senior Secured Lender:

        i) liens remain on transferred assets;

        ii) paid $1 million cash at closing;

        iii) forgives $1 million of debt; and

        iv) new loan agreement entered into with a lower interest rate and a stretched out principal payment schedule.

    b. Publicly held subordinated debentures exchange their $12.8 million of old debentures for $6 million of new debentures with a deferred maturity and higher interest rate, subordinated only to Senior Secured Lender.

    c. Trade creditors paid $7 million in cash in complete discharge of $10 million in claims.

    d. Tort claims obtain 2% of the shares in the new company.

    e. Shareholders retain 2% of their shares.

2. A purchaser through a 363 Sale could not structure a purchase transaction in this form. A 363 Sale purchaser essentially can offer only dollars and cannot dictate which creditors obtain what portion of the purchase price.

    a. For example, a 363 Sale that purports to limit the Debtor's use of the sales proceeds pursuant to some future reorganization Plan would be prohibited.

    b. Tying the approving of a 363 Sale to the vote on a future Plan is impermissible.

J. **Plan Timing**. The time line for obtaining approval of a Plan is as follows:

1. Twenty-five days notice is required for a hearing on a disclosure statement. Votes on a Plan cannot be solicited until a disclosure statement is approved. Generally, this means that 30 - 45 days passes from the filing of the disclosure statement to mailing of solicitations of acceptance.

2. Twenty-five days notice of hearing on confirmation. In practice, 30 - 45 days originally passes from the mailing of notice.

3. Under the Bankruptcy Rules, unless the Bankruptcy Court orders otherwise, the order of confirmation is not effective for 10 days.

a. Thus, a purchaser through a Plan will have to wait 11 days after the entry of the confirmation order to close, unless the court otherwise orders.

b. Recall this situation is different than a 363 Sale where, unless the sale is stayed pending appeal, a purchaser can close immediately upon entry of the 363 Sale approval order.

4. The Bankruptcy Court can shorten all of these time requirements for good cause. Time periods are frequently shortened. Purchasers should be careful about draconian time reductions as procedural due process under the U.S. Constitution must be provided to achieve proper notice.

V. PURCHASE OF ASSETS IN BANKRUPTCY THROUGH A PREPACKAGED PLAN[2]

A. **Solicitation Before Commencement of Bankruptcy Case**. Prepackaged plans involve the solicitation of votes on a plan before the filing of the bankruptcy case. Once the bankruptcy case is filed, no disclosure statement hearing or solicitation is required.

B. **Advantages of Prepackaged Plan**. The major advantages of a pre-packaged plan purchase transaction are:

1. Transactional costs are less than in a traditional bankruptcy plan.

2. Minimizes disruption to business.

3. Negotiations over purchase occur free from court process.

4. A purchaser can reach a closing in less time than acquiring a business through a traditional Plan.

C. **Disadvantages of Prepackaged Plan**. The major disadvantages of a pre-packaged plan purchase transaction are:

1. Uncertainty of coverage of securities laws exemptions (which means non-bankruptcy securities laws generally will need to be observed).

2. A purchaser must become intimately involved in the bankruptcy process to a much greater extent than does a 363 Sale purchaser.

3. More time consuming than purchasing assets through a 363 Sale.

4. The lengthy pre-bankruptcy process creates uncertainty with trade creditors.

5. As a practical matter, a purchaser often must obtain consent from an informal pre-bankruptcy committee of creditors.

[2] The discussion in Section IV above regarding the contents of a Plan and the procedure for its adoption applies to prepackaged plans except as otherwise described below.

VI. PURCHASE OF ASSETS OR CONTROL POSITION THROUGH PURCHASE OF CLAIMS AGAINST DEBTOR

A. **Substantial Block of Claims Required**. It is possible to effect an acquisition of all or a significant part of a Debtor's assets or business (or control thereof) by purchasing a sufficient amount of claims against that Debtor. Under this method, the purchaser will acquire a block of claims substantial enough to make it a material player in Chapter 11 Plan negotiations. The purchaser then will negotiate a distribution of assets or stock as its treatment under the Plan. Alternatively, if the purchaser has acquired secured claims against a Debtor, the purchaser has acquired secured claims against a Debtor, the purchaser may seek to foreclosure on the Debtor's assets, or "credit bid" all or part of the purchased secured debt when the assets are sold.

B. **Purchase Price of Claims is Committed Before Control is Achieved** the primary risk associated with this approach is that amount paid to acquire the claims is committed before the result (i.e., achieving control) is certain.

C. **Applicability of Williams Act is Uncertain**. Courts currently are divided over whether an entity purchasing the publicly-held claims of a Debtor must comply with Williams Act requirements related to tender offers for equity securities. (Williams Act, §§ 12(i), 13(d) - (e), 14(d) - (f) (amending Securities Exchange Act of 1934), 15 U.S.C. §§ 78(i), 78M(d) - (e), 78N(d) - (f) (1988).)

D. **Other Securities Issues**. One court has held that unsecured claims constitute "equity securities" and that an offer to purchase claims without a 14D-1 filing violated Section 14(d).

E. **Restrictions on Purchase of Claims by Fiduciaries**. Rules on purchasing claims are different for fiduciaries than for non-fiduciaries.

1. Typically, a fiduciary of a Debtor is restricted in the purchase of claims. If a fiduciary of a Debtor purchases claims for 10% of their face amount post-bankruptcy, numerous courts have held that fiduciary can only assert a claim against the Debtor for the consideration actually paid for the purchase of the claim, i.e., the 10%, rather than the face amount of the claim. The rationale for this rule is that a fiduciary should not profit from his/her unique knowledge. Further, the fiduciary may be usurping a corporate opportunity.

2. Members of Creditors' Committees are fiduciaries. The SEC has viewed Creditors' Committee members as "temporary insiders" as they have entered into a temporary special relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

3. Very recent case law has allowed fiduciaries to trade claims if sufficient "Chinese Wall" protection is established between the actual individuals involved in the bankruptcy case on behalf of the entity and the individuals involved in purchasing the claims on behalf of that same entity. However, the SEC has opined that trading should be permitted in this situation only by entities engaged in trading as a regular part of their business.

F. **The Bankruptcy Code and Bankruptcy Rules Have Very Few Provisions Regulating the Trading of Claims**.

1. The trading of bonds and debentures is not regulated at all.

2. Recent amendments to the Bankruptcy Rules as of August 1, 1991 limit the ability of a Court to inquire into the propriety of the purchase of claims by a non-fiduciary. Before the amendment of the Bankruptcy Rules on August 1, 1991, Bankruptcy Courts seeking to protect unsophisticated creditors had interfered with the claims, assignment process and had, on their own or at the request of Debtor's, provided rescission rights or other relief to assignees of claims).

3. The new rules provide that a claims purchaser does not need Bankruptcy Court approval to effectuate the transfer of claims.

G. **Purchased Claims are Subject to Defenses**. Purchasers of claims purchase claims with any defenses to which the claims may be subject. For example:

1. If an assignor had received a preference, the Bankruptcy Code provides that the purchase claim may not be allowable.

2. If the claim includes unmatured interest or original issue discount, the purchased claim may not be allowable in its full amount.

3. If a purchased claim arises from a rejected real estate lease, it is difficult to value.

4. A purchased claim may be subject to equitable subordination.

5. The claim purchase agreement must contain provisions dealing with any possible infirmities in the claim.

H. **Class Voting Requirements**. One significant problem for a creditor purchasing claims in an attempt to obtain control of a class for voting purposes on a Plan is the requirement under the Bankruptcy Code that 50% in number of claimants in a class must vote in favor of a Plan to constitute approval for that class.

1. It is the number of claimants rather than claims that are counted.

2. As a purchaser purchases claims, the number of claimants of a particular class are reduced.

3. For example:

   a. Assume 100 entities hold 100 claims in the amount of $1.00 in one class.

   b. A purchaser purchases 99 of those 100 claims.

   c. The purchaser then holds one claim for $99 and one other creditor holds one claim for $1.

d. As only two votes exist in that class, without the affirmative vote of the creditor holding the non-purchased one claim of one dollar, the purchaser holding the other claim for $99 (formerly 99 claims) cannot control 50% of the number of votes in that class.

e. Ironically, the greater number of claims in a class that a purchaser purchases, the more leverage holdout creditors have to extract higher payments for their claims.

4. Some purchasers have argued that the number of claims should be counted rather than the number of claimants holding the claims. In that instance, in the example above, the purchaser would have 99 votes. This interpretation would limit the holdout ability of recalcitrant creditors. Only scanty case law exists to support this position.

VII. NON-BANKRUPTCY PURCHASE OF ASSETS

A. **No Ability to Bind Non-Consenting Creditors**. Outside of bankruptcy, a purchaser will be unable to bind non-consenting creditors who do not consent to the terms of the purchase.

B. **Broader Creditor Consent Required**. As a practical matter, to effectuate a transaction of an insolvent entity outside of bankruptcy, the purchaser must obtain either:

1. The agreement of potential creditors; or

2. Those material creditors who do not agree must be paid in full according to the terms of their agreements with the Debtor.

3. Indeed the purchaser generally will find it impossible even to identify (let alone obtain consent from) a myriad of the Debtor's contingent creditors, e.g., product liability claimants, employment discrimination victims, environmental violation victims, etc.

C. **Inadequacy of Debtor's Agreements Cannot Be Remedied**. Where the Debtor already has defaulted on agreements, and cure periods have expired, even a purchaser's willingness to perform under the terms of the Debtor's original agreements may be insufficient. Creditors, in that instance, may have accelerated debt or taken other action. No forced deceleration or forced modification of agreement terms is available outside of bankruptcy.[3]

D. **Bulk Sales Act, De Facto Merger, and Successor Liability**. There is substantial risk – under the Bulk Sales Act, the de facto merger doctrine and the successor liability doctrine – that, where the purchaser acquires substantially all of an insolvent Debtor's assets outside of bankruptcy, the purchase will inherit involuntarily some or all of the Debtor's liabilities if, as seems likely, the Debtor does not pay them. In contrast, the purchaser of assets from a bankrupt entity can obtain a Bankruptcy Court order transferring assets free and clear of virtually all claims.

[3] One exception is exit consents in an exchange offer. Exit consents can be imposed by a majority or super-majority vote, thus stripping public bondholders of certain indenture protections. However, even in this instance, payment terms for a particular bondholder cannot be altered involuntarily.

E. **Non-Bankruptcy Transaction Quicker**. However, the non-bankruptcy transaction likely can be accomplished more quickly and economically.

F. **No Negative Effects of Bankruptcy Filing**. A transaction outside of bankruptcy avoids the negative effects of a bankruptcy filing on a Debtor's business operations.

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The author thanks Stephanie D. Simon, Kirkland & Ellis Associate, for her invaluable assistance in preparing this paper.