LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 39, Number 5 • March 2022

The Coming Thaw for Distressed M&A: Opportunities and Best Practices For Lenders In Financing Distressed Business Acquisitions

By Joel H. Levitin and Richard A. Stieglitz Jr.

As distressed M&A activity inevitably heats up, strategic buyers and equity sponsors that have sat on the sideline for an extended period of time will likely have expanding interest in purchasing viable, but over-leveraged, businesses that are being sold out of bankruptcy. The benefits of buying the business of a Chapter 11 debtor, such as obtaining a court order explicitly limiting assumed liabilities and containing other buyer protections, are relatively well known. This article focuses on the *financing* opportunities this activity will create for *lenders,* highlights the benefits of financing bankruptcy acquisitions, and identifies some potential challenges and best practices to ensure that lenders minimize any risks and receive maximal protection for themselves.

Joel H. Levitin and **Richard A. Stieglitz Jr.** are partners in the Bankruptcy & Restructuring practice of Cahill Gordon & Reindel LLP in New York. Levitin is also a member of this newsletter's Board of Editors. The authors can be contacted at **jlevitin@cahill.com** and **rstieglitz@cahill.com**, respectively. *The views expressed in the article are those of the authors and not necessarily the views of their clients or other attorneys in their firm.*

Bankruptcy Sales

For in-court distressed transactions, a debtor typically proposes a buyer to serve as a "stalking-horse" or platform bidder to establish a price floor and then conducts a marketing process to solicit competing bidders to participate in an auction to obtain the highest, or otherwise best, sale price. In exchange, the stalking horse generally negotiates the parameters of the sale process and certain buyer protections, including a break-up fee. Where it is not able to secure a stalking horse, the debtor often runs a similar bid solicitation process, with the hope of generating the interest of multiple bidders, so it can conduct an auction and maximize value. The debtor and its advisors, in consultation with the primary creditor constituencies, select the winning bidder, subject to the presiding bankruptcy court's review and approval. The entire sale process can often be completed in 30-60 days and does not require the resolution of any inter-creditor or other ancillary issues necessary to complete the Chapter 11 process.

Lenders may have the opportunity to finance a stalking-horse bidder or a potentially-competing bidder. Given

certain bankruptcy protections discussed below, these opportunities may actually be more attractive for lenders than non-bankruptcy financings. Any potential challenges can be mitigated by following the best practices described below.

Lender Protections

Lenders should be able to benefit from the protections a buyer receives in a bankruptcy sale. Most importantly, a buyer purchases the assets of a business out of bankruptcy "free and clear" of most claims and liabilities, other than those that it specifically assumes, allowing it to avoid the overhang of many legacy claims and litigation that may create uncertainty. The lenders, therefore, should be in a position to finance a borrower that is "cleaner" than what would be expected in a non-bankruptcy setting, with a better understanding of the risk profile of its prospective borrower and less likely to be subject to unexpected value leakage if the borrower later defaults.

In addition, because the buyer will determine which of the target's contracts to keep and which to leave behind, lenders will likely have a clearer picture of the go-forward operations and prospects of the acquired business. Lenders still, of course, need to carefully diligence certain liabilities that may in some circumstances survive bankruptcy, such as environmental, tax, and product liability claims, but the level of review can be substantially less and the process can be managed with the help of experienced professionals.

There are also some less obvious and more technical benefits for lenders. Court-approved transactions are difficult to challenge or avoid in the future. Indeed, most bankruptcy court sale approval orders will include specific findings that the sale is for fair consideration and reasonably equivalent value, making subsequent fraudulent transfer attacks, including any such challenges to the liens of lenders, futile. Even without such express language, bankruptcy sales are almost always supported by evidence of a fair and extensive sale process, again making subsequent fraudulent transfer challenges extremely unlikely to succeed.

It may also be possible to structure a bankruptcy sale to address thornier potential successor liability issues, including by making the sale part of a debtor's plan of reorganization and linked to the debtor's ultimate reorganization. Although that process can take more time and carry more risk, because it may require, among other things, the negotiation or litigation of intercreditor and other issues, and a creditor voting process, it may be a worthwhile option to consider in certain circumstances.

Challenges and Best Practices

Of course, financing a bankruptcy sale can present a few challenges for lenders. First, as mentioned above, the sale process can be accelerated, shortening the diligence process. Quality professionals can help lenders manage this process and any related risks. Lenders not only need to understand the underlying sale agreement and related documents, but also need to closely monitor the court process with the assistance of counsel.

Moreover, depending on the sale process, the industry, and any regulatory scheme that may govern the target's business, the lenders' commitment may need to remain outstanding for a relatively long period of time. Similarly, a potential buyer may agree to be a "back-up" buyer — *i.e.*, to complete the transaction if the initial winning bidder

does not do so -- in which case the lenders may need to agree to commit to contingent financing even if their borrower comes in second at the auction. To protect themselves, lenders should ensure that any commitment includes termination rights in the event the sale does not close by an acceptable outside date.

Additionally, the buyer may require the lenders to agree in advance to additional funding amounts, or "dry powder", to allow it to make higher competing bids, requiring lenders to be more flexible and nimble than in certain non-bankruptcy transactions. If possible, the commitment should be structured to allow syndication during the sale process. However, if syndication cannot be completed in the available timeframe, arranging lenders may need to be prepared to close and fund the bankruptcy sale transaction and complete syndication after closing.

Finally, lenders should make sure that they have some consent rights over the ultimate sale order and/or the ability to terminate any commitment if there are any changes to the business deal that might, even indirectly, alter the ultimate capital structure of the buyer, including in connection with resolving any objections made by any creditors or other parties to the sale.

Conclusion

Financing bankruptcy acquisitions is likely to become a significant source of lending opportunities in the coming market. With proper attention and support, a bankruptcy sale process can be even more easily managed by lenders and their professionals than a non-distressed acquisition process, and the end result is likely to be a more certain borrower profile and therefore a less risky loan.

The chart below summarizes the potential challenges inherent in financing a bankruptcy sale transaction and how those challenges can be managed.

Challenge	Best Practices to Manage
Shorter diligence period.	Diligence can be managed with help of experienced professionals. Make sure sale order/plan of reorganization contains appropriately broad free and clear language and will be enforceable.
Uniqueness of bankruptcy process.	Retain experienced professionals. Make sure to understand nuances of court process and orders.
Some liabilities harder to leave behind	Consider plan sale and other structures. Factor risk into terms of ultimate business deal (*e.g.*, specific termination rights for commitment and reserves for credit agreement).
Long or indefinite period of commitment.	Negotiate ability to terminate commitment if not closed after acceptable outside date.
Buyer needs flexibility to bid at auction.	Make sure to understand buyer's needs and expectations for amount of available financing at commitment stage and prior to auction.
Expedited syndication process.	Be flexible and prepared to fund bridge loan, if necessary, and syndicate after closing.
Debtor/seller manages process, and bankruptcy court has ultimate authority over process and sale order.	Negotiate extensive termination rights that overlap with, but are not dependent on, buyer's ability to terminate.

Reprinted with permission from the March 2022 edition of the LAW JOURNAL NEWSLETTERS. © 2022 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-256-2472 or reprints@alm.com. # LJN-3022022-545564