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Asset Purchaser's Guide to Bankruptcy Sales

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An Asset Purchaser's Guide to Bankruptcy Sales

Many asset purchasers have known for years that assets of insolvent companies, including companies in bankruptcy, can be obtained at bargain basement prices. Such deals have become highly publicized since the dot-com fallout of the late 1990s.

A recent example of such bargains can be found in the expected sale of the one-time, telecommunications darling, Global Crossing. Prior to its bankruptcy filing, Global Crossing had laid approximately 100,000 miles of high capacity, fiber-optic cable under the Atlantic and Pacific Oceans, and provided voice and data services to 27 countries and more than 200 major cities.[1] Shortly after the Bermuda-based, telecommunications company filed its Chapter 11 bankruptcy petition, a Hong Kong and Singapore-based joint venture, Hutchison Telecommunications Limited ("Hutchison") and Singapore Technologies Telemedia Pte Ltd ("STT") bid $750 million to buy a 79% stake in Global Crossing - only a fraction of the estimated $22.4 billion price tag on the company's assets. The deal collapsed after Global Crossing's creditors opposed the "fire-sale price." However, after failing to obtain higher and better bids, Global Crossing agreed to sell a 61.5% interest in the reorganized entity to the joint venture for only $250 million. Although Hutchison ultimately withdrew its offer after the United States Committee on Foreign Investment raised concerns that Hutchison founder and billionaire Li Ka-shing's close ties to the Chinese government compromised U.S. national security interests, it is nevertheless expected that STT and/or the American telecommunication giant, IDT, will acquire a 61.5% stake in Global Crossing for a mere $250 million.[2]

Similarly, late last year, a Florida-based pharmaceutical company, Vitacost.com, purchased a fully operational website founded by C. Everett Koop, President Reagan's former Surgeon General, for only $186,000. DrKoop.com, which attracted more than 900,000 visitors per month and had a database of more than two million registered users, was funded with more than $200 million. It reached a market capitalization of more than $1 billion before the Internet stock market crash of the late 1990s. See Vitacost.com Acquires Dr.Koop.com for Cash, Associated Press, July 16, 2002.

Despite the many lucrative deals that abound, however, potential purchasers of assets from a bankrupt or insolvent company should be aware of potential risks inherent in every sale. This essay discusses several risks commonly faced by purchasers of assets from a debtor or otherwise insolvent corporation, and suggests several strategies to help minimize these risks.

1. SECTION 363 SALES

Generally, there are two procedural ways for assets to be acquired in a Chapter 11 bankruptcy case. First, all or substantially all of a debtor's assets can be administered through a Chapter 11 plan of reorganization. Second, the debtor's assets can be sold early on in a bankruptcy case through what has become known in bankruptcy parlance as a "section 363 sale." This essay discusses the later procedural mechanism for accomplishing such sales, which procedure has become increasingly common in recent years.

A bankruptcy trustee or debtor in possession may sell property of the bankruptcy estate outside the ordinary course of business after notice and a hearing. 11 U.S.C. § 363. The so-called "section 363 Sale" is often characterized as having a "cleansing effect" on assets that might otherwise be subject to certain liens, encumbrances or interests.

Generally, bankruptcy assets may only be sold outside the ordinary course of business if any one of the following requirements are satisfied: (1) applicable non-bankruptcy law permits such sale; (2) an entity whose lien, encumbrance or interest consents to such sale; (3) such interest is a lien and the price at

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[1] See Rep. Jim Saxton, Sale of Telecom Firm to China Poses Espionage Threat, INSIGHT MAGAZINE, Vol. 18, Issue 10, May 12,2003, 293, available at 2003 WL 2062640; Hutchison Bows Out of Global Crossing Deal; IDT Offer Could Resurface, Vol. 23, Issue 18, FIBER OPTIC NEWS, May 5, 2003, available at 2003 WL 7834667.

[2] See Keeping Out Li Ka-shing, THE ECONOMIST, May 3, 2003, available at 2003 WL 6245933; Hutchison Bows Out of Global Crossing Deal; IDT Offer Could Resurface, Vol. 23, Issue 18, FIBER OPTIC NEWS, May 5, 2003, available at 2003 WL 7834667.

which such property to be sold is greater than the aggregate value of all liens on such property; (4) there is a bona-fide dispute concerning such interest; or (5) such entity could be compelled to accept a money judgment in satisfaction of such interest. Id. § 363(f). If any one of these requirements are satisfied, section 363(f) authorizes such sale "free and clear" of any interest in such property. Id.

2. POTENTIAL RISKS TO ASSET PURCHASERS

Asset purchasers should consider the following three categories of potential risks when deciding whether to purchase assets from a bankrupt or insolvent entity: (1) possible successor liability arising from certain unknown tort claims that, although arising pre-petition, do not become known until after the bankruptcy filing; (2) competitive bidding designed to encourage the highest and best bid for the bankruptcy estate; and (3) possible avoidance of pre-petition sales for less than fair market value. As discussed below, careful planning and negotiation can minimize the risk to asset purchasers when buying an asset from a bankrupt or insolvent entity.

a. Successor Liability Claims

Generally, "a corporation which acquires another corporate entity's assets does not assume the seller's liabilities unless (1) the buyer expressly assumes those liabilities; (2) the transaction constitutes a merger or consolidation; (3) the buyer is a mere extension of the seller; or (4) the transaction amounts to a fraudulent or collusive attempt to avoid the seller's liabilities." In re Savage Indus., Inc., 43 F.3d 714, 717 n. 4 (1st Cir. 1994)(citing Conway v. White Trucks, 885 F.2d 90, 93 (3d Cir. 1989)(other citations omitted)).[3]

In the bankruptcy context, the "free and clear" language of section 363(f) has proven to be troublesome in the area of successor liability. Several courts have held that the "free and clear" language only insulates property against which specific interests, such as liens, attach (e.g., in rem interests). See, e.g., Fairchild Aircraft, Inc. v. Cambell, 184 B.R. 910, 917 (Bankr. W.D. Tex. 1995)("[N]o one can seriously argue that in personam claims have, of themselves, an interest in such property."); In re White Motor Credit Corp., 75 B.R. 944, 948, 951 (Bankr. N.D. Ohio 1987) (declining to impose successor liability on asset purchaser because "[t]he successor liability specter would chill and deleteriously affect sales of corporate assets, forcing debtors to accept less on sales to compensate for this potential liability"); In re New England Fish Co., 19 B.R. 323 (Bankr. W.D. Wash 1982). Other courts, however, would apparently allow tort claims to attach to specific property. See, e.g., Chicago Truck Drivers, Helpers & Warehouse Workers Union Pension Fund v. Tasemkin, Inc., 59 F.3d 48, 51 (7th Cir. 1995)(recognizing that the fact that creditors who possess successor liability claims may receive more than those who do not does not require an absolute prohibition on successor liability claims); Zerand-Bernal Group, Inc. v. Cox, 23 F.3d 159, 163 (7th Cir. 1994)(noting that extinguishing state law rights in order to increase the value of the debtors' property, "would not only . . . harm . . . third parties . . ., but [would provide an] incentive to enter bankruptcy for reasons that have nothing to do with bankruptcy"); In re All American of Ashburn, Inc., 56 B.R. 186 (Bankr. N.D. Ga. 1986)(reaffirming earlier decision that "the sale of the debtor's assets, approved by the Bankruptcy Court as free and clear of all claims, precludes the application of the successor doctrine against a purchase of those assets in a suit based on the debtor's alleged employment discrimination and violation of employees' civil rights").[4]

The salient question in determining whether a successor-liability action can be discharged through a section 363 Sale or through a Chapter 11 Plan is whether such liability is a "claim" as that term is defined by the Bankruptcy Code.[5] If the action is a pre-petition claim, some courts have held that the asset sale can be approved free and clear of that claim and the claim can be discharged

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[3] California, New Jersey and other states have adopted a "hybrid" exception known as "'product-line' liability" which precludes implied successor liability for products liability cases. Id. The seller must show the following: "(1) the total or virtual extinguishment of tort remedies against the seller as a consequence of an all-asset sale; (2) the buyer's continued manufacture of the same product lines under the same product names; (3) the buyer's continued use of the seller's corporate name and identity and trading on the seller's good will; and (4) the buyer's representation . . . to the public that it is an ongoing enterprise." Id. (citations omitted).

through a Chapter 11 plan.[6] If the action is not a claim, the asset purchaser could be saddled with significant successor liability that would not be discharged. "Despite the various permutations in fact matters and reasoning, virtually all the cases conclude that unknown tort claims cannot be discharged and precluded from future recoveries unless their interests have been adequately represented within the bankruptcy proceeding." In re UNR Indus., Inc., 224 B.R. 664, 672 (Bankr. N.D. Ill. 1998).

The Third Circuit Court of Appeals recently affirmed the bankruptcy court's approval of the sale of TWA's assets to American Airlines "free and clear" of certain employment discrimination claims and the flight attendants' rights under a travel voucher program which TWA had established in settlement of a sex discrimination action (the "successor liability claims"). See In re Trans World Airlines, Inc., 322 F.3d 283 (3rd Cir. 2003) ("TWA"). The court held that the successor liability claims were "interests in property" for purposes of 11 U.S.C. section 363(f), "which 'encompasses other obligations that may flow from ownership of the property.'" Id. at 289 (citing 3 Collier on Bankruptcy ¶ 363.06[1]). The court noted that "to equate interests in property with only in rem interests such as liens would be inconsistent with section 363(f)(3), which contemplates that a lien is but one type of interest." Id. at 290. The court further held that even if the successor liability claims were not interests in property, they were nevertheless general unsecured claims entitled to share pari passu with other unsecured creditors. Id. at 291-93. Finally, the court noted that "[a]bsent entry of the Bankruptcy Court's order providing for sale of TWA's assets free and clear of the successor liability claims . . ., American may have offered a discounted bid." Id. at 292-93. Thus, the Third Circuit permitted the removal of successor liability claims from assets purchased under section 363.

Because of the split of authority regarding this issue, this article will assume for purposes of discussion that a tort claim unknown at the time of the asset sale "can" be asserted against the asset purchaser.

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[4] Courts have developed several tests to determine whether a claim can be asserted against a successor-in-interest:

a. Conduct Test

Under the conduct test, a claim arises when conduct giving rise to the alleged liability occurred. In re Kewanee Boiler Corp., 198 B.R. 519, 531 (Bankr. N.D. Ill. 1996)(citations omitted).

b. Pre-Petition Relationship Test

The pre-petition relationship test requires that "potential future claimants have entered into some kind of relationship with debtor at the time they were injured or earlier. Thus, if their injury occurs post-petition, only if they purchased, used, operated, or came in contact with debtor's defective product in their ordinary activity pre-petition, [are] they found to have a pre-petition claim." Id.

c. State Accrual Test

The state accrual test focuses on state law to determine if and when a claim exists that may be addressed through the bankruptcy process. Avellino Bienes v. M. Frenville Co., 744 F.2d 332, 335-36 (3d Cir. 1994).

d. Due Process Test

In Fairchild Aircraft, Inc. v. Cambell, 184 B.R. 910 (Bankr. W.D. Tex. 1995), the court recognized the broadest possible relief available that does not "ride roughshod over due process and notions of fundamental fairness." Id. at 927. Thus, for example, a claim cannot be discharged if the claimant was not given notice and an opportunity to respond.

e. Fair Contemplation Test

The Ninth Circuit Court of Appeals and other courts have adopted the "fair contemplation" test, at least in the context of CERCLA claims. See In re Jensen, 995 F.2d 925 (9th Cir. 1993). Under this test, a claim may only be deemed pre-petition if it is "based upon pre-petition conduct that can be fairly contemplated by the parties at the time of the debtors' bankruptcy." Id. at 930 (citation omitted).

[5] The term, "claim," is broadly defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . . ." 11 U.S.C. § 101(5).

[6] Of course, these courts ignore the distinction between in rem claims, which look to specific property for recovery, and in personam claims, which can be pursued against the entity. Arguably, a products liability claim or tort claim are in personam claims that do not attach to specific property. Thus, the "free and clear" language should presumably not apply. Nevertheless, as discussed above, numerous courts have ignored this distinction.

i. Strategies for Coping with potential successor liability claims

The following strategies should be considered by a potential asset purchaser prior to entering into negotiations to purchase the assets of a bankrupt or insolvent debtor.

(1) Reserve Fund and the Appointment of a Representative for Unknown Claimants

A proposed purchaser will generally request that the asset purchase agreement include a provision expressly stating that the sale is free and clear of all claims against the debtor, whether known or unknown, liquidated or unliquidated, and releasing or discharging the asset purchaser from any successor liability. If it is likely that substantial unknown claims exist, the asset purchaser may desire additional protection by having the debtor set aside a reserve to pay unknown tort claimants based upon certain historical assumptions about the company's business, and actuarial calculations of damages, injuries or deaths occurring in the same industry. For example, an actuary can be retained to estimate the number of injuries or deaths per year which may occur as a result of the manufacture, use or sale of any given product manufactured or sold pre-petition. Based upon the actuary's analysis, the proposed purchaser can demand that the debtor set aside a large enough fund to pay such tort claims in full.

The reserve or trust fund device has been widely used in mass tort cases involving asbestosis, agent orange, the Dalcon Shield and silicone implants, where tort claimants often do not know that they have a claim against the debtor, or successor-in-interest, until years after the tort occurred. See, e.g., In re National Gypsum Co., 257 B.R. 184, 197 (Bankr. N.D. Tex. 2000)(trust established for estimating non-discharged asbestos disease claims over the next 40 years and retaining an expert to value those claims in the tort system), cert. denied, 532 U.S. 1075, 121 S. Ct. 2238, 150 L.Ed. 227 (2001); see also In re UNR Indus., Inc., 224 B.R. 664, passim (Bankr. N.D. Ill. 1998)(and cases cited therein). In order to ensure that a claimant's due process rights are protected, the courts often appoint a representative to represent the unknown future claimants. Id.; Kewanee Boiler, 198 B.R. at 528-29 (recognizing that the due process concern for ensuring that a creditor who had no way of knowing that it may have a claim against the debtor some time in the future may be adequately addressed by the establishment of a trust fund for future claimants and the appointment of a representative to articulate the interests of future claimants); National Gypsum, 257 B.R. at 187 (noting that the court previously appointed a legal representative "to advocate the interests of the unknown and future asbestos disease claimants").

(2) Discount

Frequently, a company that may have significant unknown claims against it may agree to discount its assets in an amount sufficient to cover potential successor liability claims. See TWA, 322 F.2d at 292-93 (opining that American Airlines would have offered a discounted bid had the sale not been free and clear of successor liability claims). Unfortunately, however, it is often difficult to determine an accurate discount rate because any given year may have significantly more or less claims than might fall within the statistical average. Thus, an asset purchaser may get a windfall if fewer than expected successor liability claims are asserted against it. Conversely, an asset purchaser may be saddled with significant new debt that was unanticipated if greater than expected successor liability claims are asserted against it. Thus, any discount in price should only be used as one of the panoply of tools available to purchasers of assets in bankruptcy.

(3) Conditional Offer

Finally, an offer to purchase assets from a debtor or insolvent company can be conditioned upon a bankruptcy court's approval of a purchase agreement that removes all claims, including unknown or future, pre-acquisition tort claims from assets of the asset purchaser. If the debtor or insolvent company does not obtain court approval of this condition, the asset purchaser can terminate the purchase agreement for cause. See, e.g., TWA, 322 F.3d at 292-93 (recognizing that the sale was likely facilitated by the buyer obtaining the assets free and clear of successor liability claims).

In sum, purchasers of assets from a debtor or insolvent company have various tools at their disposal to minimize the impact of potential successor liability claims. This essay is not exhaustive of the tools available, but is only intended to make the potential asset purchaser aware of the risks, and some of the mechanisms that may be used to minimize these risks.

b. Bidding Procedures and Incentives

Although a debtor-in-possession's decision to sell its assets outside the ordinary course of business is protected by the business judgment rule, In re Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983); In re Plaza Family Partnership, 95 B.R. 166, 173 (E.D. Cal. 1989), "the ultimate purpose [of such sale should be] to obtain the highest price for the property sold." In re Wilde Horse Enters., Inc., 136 B.R. 830, 841 (Bankr. C.D. Cal. 1991)(citing In re Chung King, Inc., 753 F.2d 547 (7th Cir. 1985); (other citations omitted)). "In approving any sale outside the ordinary course of business, the court must . . . find [that the proposed sale] . . . is in the best interest of the estate, i.e. it is fair and reasonable, that it has been given adequate marketing, that it has been negotiated and proposed in good faith, that the purchaser is proceeding in good faith, and that it is an 'arms-length' transaction." Wilde Horse, 136 B.R.. at 841-82 (citations omitted). To accomplish these objectives, courts generally require that the proposed sale be subject to overbids.

However, in order to incentivize the proposed purchaser to be the so-called "stalking horse," sellers are often required to give the buyer some protection should the proposed sale not be consummated through no fault of the buyer. This is because a buyer does not want to be used by the debtor to obtain a higher bid or to incur substantial costs in performing its due diligence. A "breakup fee" is often used to pay the potential buyer if the proposed sale is not consummated through no fault of the buyer. In large cases, the breakup fee can be substantial. Similarly, a "topping fee" may be used to pay the initial buyer a certain percentage of the difference between the buyer's initial bid, and the successful bid. These devices can be used separately or together, and are often approved by bankruptcy courts if they are reasonable and do not chill the bidding process. See, e.g., In re American West Airlines, Inc., 166 B.R. 908-12 (Bankr. D. Ariz. 1994).

As part of the sale negotiations, the proposed buyer should try to negotiate a breakup fee and topping fee to compensate it for the time and costs incurred for agreeing to bring the first bid to the table.

c. Possible Bankruptcy Court Disapproval of Pre-Bankruptcy Sales

It is possible that a sale entered into between a proposed asset purchaser and an insolvent entity on the eve of bankruptcy may be unwound by the bankruptcy court if the court determines that the sale was not sufficiently exposed to the market place or subject to the best and highest bid. For example, in In re United Healthcare System, Inc., 1997 LEXIS 5090, at *19-20 (D.N.J. 1997), the bankruptcy court voided a pre-petition sale of an acute care hospital to an entity that agreed to maintain the legacy of the children's hospital on the basis that the debtor should have accepted higher and better competing bids. The district court reversed, stating that the bankruptcy court

improperly focused its overwhelming attention on the monetary aspects of competing bids when the debtor's board of directors had a fiduciary duty to maintain the legacy of the children's hospital. Id. at 20.

It is good practice for a proposed buyer to make sure that the assets that it seeks to obtain are exposed to the marketplace and subject to overbids. Otherwise, the transactions may be unwound by the bankruptcy court to afford the debtor an opportunity to seek the best and highest bid. Alternatively, if the transaction cannot be unwound, it is possible that the buyer could be required to pay the difference between the purchase price and the fair market value of the asset as a fraudulent conveyance under 11 U.S.C. sections 544 and 547.

CONCLUSION

Investors who seek to acquire assets of an insolvent corporation or a corporation in bankruptcy can often do so at bargain basement prices. However, they need to take steps to minimize certain risks associated with such sales. Generally, it is in the asset purchaser's interest to make sure that a pre-bankruptcy sale is adequately exposed to the marketplace and is subject to overbids. In the post-bankruptcy context, the proposed buyer should try to negotiate break-up and topping fees to ensure that if the transaction fails through no fault of the purchaser, or the debtor's assets are sold to an overbidder, it nevertheless is adequately compensated for such risks. Finally, a proposed buyer may minimize the risk of successor liability by (a) requiring the debtor to set aside a sufficient reserve to pay unknown or future claims, (b) obtaining a discount based upon estimated successor liability claims and/or (c) negotiating a provision in the purchase agreement that releases the purchaser from any successor liability claims. While neither the risks discussed in this essay, nor the proposed mechanisms for minimizing the risks, are exhaustive, this essay hopefully raises awareness regarding these issues.